ISLAMIC FINANCIAL
SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2016

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STABILITY REPORT

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions, and market players.

For more information about the IFSB, please visit **www.ifsb.org.**

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AMA	Advanced Measurement Approach
AML	anti-money laundering
ASA	Alternative Standardised Approach
ASEAN	Association of South-East Asian Nations
AuM	assets under management
BCBS	Basel Committee on Banking Supervision
BCG	Basel Consultative Group
BCPs	Core Principles for Effective Banking Supervision (or Basel Core Principles)
BCR	Basic Capital Requirements
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
bps	basis points
CAGR	compound annual growth rate
CAR	capital adequacy ratio
CBB	Central Bank of Bahrain
CCP	central counterparty
CFT	countering the financing of terrorism
CGFS	Committee on the Global Financial System
CIS	collective investment schemes
CMGs	crisis management groups
ComFrame	Common Framework
CPs	core principles
CPIFR	Core Principles for Islamic Finance Regulation
DFIs	development financial institutions
DIS	deposit insurance scheme
DJIM	Dow Jones Islamic Market
D-SIBs	domestic systemically important banks
ECB	European Central Bank
ECCA	Europe and Central Asia region
ECL	expected credit loss
ECRA	External Credit Risk Assessment Approach
ED	Exposure Draft
EMDEs	emerging markets and developing economies
EPAC	East Asia and Pacific region
EPF	Employee Provident Fund
ETF	exchange-traded fund
FATF	Financial Action Task Force
FDR	financing-to-deposit ratio
FIS	facilitating the implementation of the IFSB standards
FMI	financial market infrastructure

FOMC	Federal Reserve's Open Market Committee
FSA	Financial Services Act 2013
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSI	Financial Stability Institute
FSRs	Financial Stability Reports
FSRB	FATF-Style Regional Bodies
G-20	Group of Twenty
GCC	Gulf Cooperation Council
GDP	gross domestic product
GFC	Global Financial Crisis
GFSR	Global Financial Stability Report
GN	Guidance Note
GRE	government-related entity
G-SIBs	global systemically important banks
G-SIFIs	global systemically important financial institutions
G-SIIs	global systemically important insurers
HLA	higher loss absorbency
IADI	International Association of Deposit Insurers
IAHs	investment account holders
IAIS	International Association of Insurance Supervisors
ICD	Islamic Corporation for the Development of the Private Sector
ICIS	Islamic collective investment schemes
ICM	Islamic capital market
ICPs	Insurance Core Principles
ICS	Insurance Capital Standard
IDB	Islamic Development Bank
IFC	International Finance Corporation
IFFIm	International Finance Facility for Immunisation
IFI	Islamic financial institution
IFSA	Islamic Financial Services Act 2013
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IFSISR	Islamic Financial Services Industry Stability Report
IIFS	institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
ILAAP	internal liquidity adequacy assessment
IMF	International Monetary Fund
IO	international organisation
IOSCO	International Organization of Securities Commissions
IRB	internal-ratings based
IRRBB	interest rate risk in the banking book
IRTI	Islamic Research and Training Institute

LCR	liquidity coverage ratio
LOLR	lender of last resort
MDBs	multilateral development banks
MENA	Middle East and North Africa
MFI	microfinance institution
MIX	Microfinance Information Exchange
MMF	money market fund
MSME	micro, small and medium
NPFs	non-performing financing/facilities
NPLs	non-performing loans
NPONSFR	net stable funding ratio
OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
OTC	over the counter
PIF	participants' investment fund
PRF	participants' risk fund
PSIAs	profit-sharing investment accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
QE	Quantitative Easing Programme
RCAP	Regulatory Consistency Assessment Programme
REIT	real estate investment trust
ROA	return on assets
ROE	return on equity
ROSCs	Reports on the Observance of Standards and Codes
RPSIA	restricted profit-sharing investment account
RRF	*Retakāful* Risk Fund
RSAs	regulatory and supervisory authorities
RTO	*Retakāful* Operator
RWA	risk-weighted assets
SA	Standardised Approach
SAFR	Sub-Saharan African region
SALR	short-term asset–liability ratio
SAMA	Saudi Arabian Monetary Agency
SAPR	self-assessment and peer review
SASI	South Asian region
SCDIS	Sharī'ah-compliant deposit insurance schemes
SCRA	Standardised Credit Risk Assessment Approach
SHF	shareholders' fund
SIBs	systemically important banks
SIFIs	systemically important financial institutions
SIG	Supervision and Implementation Group
SKRA	strategic key result area
SLOLR	Sharī'ah-compliant lender of last resort
SMEs	small and medium-sized enterprises

SPFO	Strategic Plan and Financial Outlook
SPP	Strategic Performance Plan
SPV	Special Purpose Vehicle
TA	technical assistance
TC	Technical Committee
TLAC	total loss-absorbing capacity
TN	Technical Note
TO	*Takāful* Operator
UAE	United Arab Emirates
UN	United Nations
UNDP	United Nations Development Programme
UPSIA	unrestricted profit-sharing investment accounts
US	United States
USD	United States Dollar
WB	World Bank
WG	working group
WHO	World Health Organization
WP	Working Paper
XOF	CFA Franc

GLOSSARY

Bayʿ al-ʿĪnah	The sale of a commodity for a spot price and its repurchase for a deferred price higher than the spot price. Reverse ʿīnah is the sale of a commodity for a deferred price and its repurchase for a spot price lower than the deferred price.
Bayʿ al-Istijrār	A sale contract in which a customer receives the commodities gradually without an agreement on the price of such commodities or, in most cases, the payment of a portion of it. The price of the commodities will be determined later after the commodities have been consumed. This contract is similar in nature to the supply contract.
Bayʿ Bil Thaman al-Ājil	Sale contract based on deferred payment at a certain price.
Commodity *Murābaḥah*	A Murābaḥah transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred murābaḥah, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
Diminishing *Mushārakah*	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or at the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Ijārah	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. As for the *ijārah* contract, it is binding on both contracting parties.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharīʿah-compliant, with separate funds. It could also provide *takāful* or *retakāful* services.
Istisnāʿ	The sale of a specified asset, with an obligation on the part of the seller to manufacture/construct it using his own materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or instalments.
Kafālah bi al-Ajr	A guarantee with fee.
Muḍārabah	A partnership contract between the capital provider (Rabb al-Māl) and an entrepreneur (Muḍārib) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
Murābaḥah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin. The *Murābaḥah* contract can be preceded by a promise to purchase from the customer.
Mushārakah *(Sharikat al-ʿAqd)*	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the *mushārakah* contract, while losses are shared in proportion to each partner's share of capital.

Qarḍ	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.
Salam	The sale of a specified commodity that is of a known type, quantity and attributes for a known price paid at the time of signing the contract for its delivery in the future in one or several batches.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (*Ijmā'*), analogy (*Qiyās*) and other approved sources of the Sharī'ah.
Sharī'ah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharī'ah compliance and governance system.
Sharī'ah non-Compliance Risk	An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī'ah in its products and services.
Sukūk	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant
Takāful	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
Wadī'ah	A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.
Wakālah	An agency contract where the customer (principal) appoints an institution as agent (*Wakīl*) to carry out the business on his behalf. The contract can be for a fee or without a fee.
Waqf	A property that produces income and that may have been deeded to benefit a community.
Zakāh	An obligatory contribution or tax which is prescribed by Islam on all Muslims having wealth above an exemption limit at a rate fixed by the Sharī'ah. The objective is to make available to the state a proportion of the wealth of the well-to-do for distribution to the poor and needy.

FOREWORD

The fourth edition of the Islamic Financial Services Board's (IFSB) Islamic Financial Services Industry Stability Report takes place against a challenging economic backdrop that has led to a moderation in 2015 of the high growth rates of Islamic finance observed since the global financial crisis. Increasing concern about volatility in the global financial system has been a feature in 2015, underscoring the importance of developing strong regulatory frameworks for prudential regulation and supervision in Islamic finance jurisdictions, supported by proactive stress testing and an enhanced set of capabilities for macroprudential surveillance. These issues continue to be central to the IFSB's mission, as is elaborated in this report.

In terms of global economic developments, a key concern is the slowdown in China's economic growth which is having wider ramifications, including on commodity prices and lower prospects for global economic growth, while also contributing to elevated risk perceptions among global investors. These risk perceptions were further aggravated in the light of unsettling movements in Euro area bond markets and, at least initially, concern over the possibility of a "disorderly withdrawal of unconventional monetary policy" in the United States. Underlying these developments was what appeared to be a dissonance between the outlook of the authorities, and market perceptions in advanced economies. Carefully modulated responses by the Federal Reserve in 2016, are contributing towards greater convergence in these perceptions, which is likely to reduce instability in the global financial system.

This is important as global economic prospects appear divergent, with the pace of economic growth slowing in emerging economies. The divergence has been accompanied by uncertainty in financial markets. Many emerging markets have had difficulty in coping with the resulting sharp swings in gross cross border capital flows. A few have been able to absorb volatile capital flows through flexible exchange rate adjustment and, in some cases, the countervailing presence of domestic financial intermediaries with strong balance sheets has helped to stabilise net capital flows. For other economies with unhedged corporate debt in dollar denominated terms, adjustment has been difficult in view of the appreciation of the US dollar. Most emerging economies, including those in which Islamic finance has a presence, have been adversely affected by the decline in global trade flows.

Against this backdrop, this report examines the implications on the global Islamic financial services industry (IFSI) of recent economic developments and changes in the global regulatory and supervisory frameworks. The robust and sustained growth of Islamic finance over the past decade has led to the emergence of systemically important Islamic banking sectors in an increasing number of jurisdictions. As such, there are a new of set of challenges created for financial sector stability in these jurisdictions, differing by the relative importance of the respective segments (Islamic banking, Islamic capital markets and *takāful*). These require a strong and sustained policy and regulatory response.

The IFSB's IFSI Stability Report 2016 seeks to illuminate these issues for the IFSB's wide membership, as well as for all those who have a substantive interest in the stability and resilience of Islamic finance.

Chapter 1 provides an overview of the global IFSI as well as updates on trends and developments in the three sectors of the industry – Islamic banking, the Islamic capital market and *takāful*.

Chapter 2 examines the initiatives undertaken by international standard-setting bodies to further ensure the stability of the financial institutions and markets, as well as the implications of such reforms for institutions offering Islamic financial services (IIFS). It also reviews the progress of various projects and initiatives undertaken by the IFSB to enhance the supervisory framework so as to ensure stability and soundness of the IFSI. These initiatives include the development of new standards for the IFSI, namely Technical Note on Stress Testing for IIFS and Guiding Principles for Disclosure of Islamic Capital Market Products.

Chapter 3 assesses the resilience of the Islamic financial system, which includes technical analysis of selected indicators as well as assessment of risks and vulnerabilities in the three sectors. We also include a box article by Bangladesh Bank, which examines the financial stability of the Islamic banking system in the jurisdiction. I am deeply grateful for the inputs provided by Bangladesh Bank, which is a member of the IFSB Council.

Finally, Chapter 4 addresses emerging issues in Islamic finance that have been identified as a priority in the new IFSB Strategic Performance Plan (2016-18). Three issues are discussed in the chapter, which include: (a) Cross-Sectoral Links between Sectors of the IFSI and Implications for Systemic Stability; (b) AML/CFT Regulations and Islamic Financial Services Industry; and (c) Assessing Regulatory Consistency in the Implementation of Global Prudential Standards. This chapter also benefits from contributions by the European Banking Authority (EBA) which provides an overview of its work on convergence of banking supervisory practices in the European Union. We hope that this form of collaboration with other institutions will lead to the development of a global network of expertise that can help to increase awareness and understanding of emerging issues faced by the IFSI.

The IFSI Stability Report 2016 was produced by a core team from the Technical and Research Division of the IFSB Secretariat, led by Mr Zahid ur Rehman Khokher, Assistant Secretary-General, and comprising Mr Syed Faiq Najeeb and Mr Tarik Akin, who contributed to the first three chapters of the Report. Mr Farouq Abdul Jalil worked as the Project Coordinator, whereas other contributions to chapter 2 were made by Mrs Kartina Md Ariffin, Mr Md Salim Al Mamun, Mrs Dian Dannira, Mr Erdem Oz, and Ms Aminath Amany Ahmed. Overall, the staff of the IFSB were responsible for preparing three out of four chapters of the Report.

For Chapter 4, Professor Volker Nienhaus authored the section on cross-sectoral links between sectors in Islamic finance while the sections on AML/CFT regulations and regulatory-consistency assessment programme (RCAP) were written by Mr Prasanna Seshachellam. Mrs Siti Rosina Attaullah contributed to the assessment of Islamic banking sector resilience. The report also benefited from constructive comments and feedback from Professor Volker Nienhaus and Mr Peter Casey on all the sections of the report. Mrs Siham Ismail, Head, and Ms Rosmawatie Abdul Halim, of the Communications and Awareness Programmes at the IFSB, provided assistance in the formatting and publication of the final document.

We hope that the IFSI Stability Report 2016 will serve not only as a useful complement to the better understanding of issues by the various stakeholders of the IFSB, but also contribute to a wider cross-border engagement on stability issues in Islamic finance, while helping to strengthen the building blocks needed for greater resilience.

JASEEM AHMED
Secretary-General, IFSB
May 2016

EXECUTIVE SUMMARY

The year 2015 saw a deceleration in the rapid growth that has characterised the Islamic financial services industry (IFSI) since the aftermath of the global financial crisis. It is too early to draw strong inferences from the evidence of a single year. However, macroeconomic developments and factors such as lower commodity prices, particularly of hydrocarbons, have impacted jurisdictions in which Islamic finance has a large presence. In addition, it may well be the case that the strong growth of Islamic in the early years after the global crisis, driven by emerging market growth and fueled by an expansionary stage of their credit cycles, is now moderating.

Islamic banking remains by far the largest sector of the IFSI. Its market share has increased in more than half of the 31 tracked jurisdictions, and the number of countries where Islamic banking is systemically important (i.e. where it accounts for more than 15% of total banking assets) increased to 11, with 84% of the global *sukūk* outstanding also concentrated in these markets. A number of new Islamic banks have been established, particularly in North and Sub-Saharan Africa where Islamic finance has taken root. As the size of Islamic banking assets shows a positive association with oil revenues, the liquidity and profitability of Islamic banks may be adversely impacted by low oil prices. Deposits from governments and government-related entities may decrease and the overall asset quality may deteriorate. But there are also opposite effects: if governments resort to external sources of financing for infrastructure projects and budget deficits, institutions offering Islamic financial services (IIFS) could find new business opportunities in financing and in *sukūk* markets. IIFS are sufficiently capitalised to sustain the additional risks, and they have reduced concentration risks by scaling down exposure to real estate and energy projects. Liquidity management remains a prime challenge, especially in jurisdictions where no active Sharī'ah-compliant interbank market has emerged.

The Islamic capital markets have experienced volatile movements and recent setbacks, including contractions in returns and asset values. The volume of *sukūk* issuances dropped by more than 50% in 2015 after the Malaysian central bank terminated its regular issuances of short-term *sukūk*. The *sukūk* market is still dominated by sovereign and multilateral issuers (70% of all issuances in 2015). The global corporate issuances from Gulf Cooperation Council (GCC) countries were primarily by IIFS (including three perpetual Additional Tier-1 *sukūk*), while issuers in Asia (in particular, Malaysia) come from a wider range of industries, such as construction, transportation and retail. Regulatory reforms such as Basel III, as well as IFSB-15 and Guidance Note 6 (GN-6) are expected to lead to an increased demand for highly rated *sukūk* that meet regulatory requirements. The share of short-term *sukūk* has decreased, while that of *sukūk* with maturities of three–five years and five–ten years increased to 22% and 39%, respectively, in 2015. The sovereign *sukūk* sector may gain momentum in 2016 on the back of increased budget deficits, particularly in the energy-exporting countries. Although there has been no instance of a *sukūk* default since 2010, a strengthening of legal frameworks and regulations regarding *sukūk* resolution in default cases could facilitate more international *sukūk* issuances.

As in previous years, Islamic equity indices outperformed their conventional counterparts. The loss experienced by the Dow Jones Islamic Market (DJIM) World Index (DJ Islamic) in the stock-market downturn of 2015 was 1.15 percentage points less than that experienced by the Dow Jones Global Index (DJ Global). A main explanatory factor is the different sectoral compositions of these indices. The DJ Global comprises a large share of financials that are absent from the DJ Islamic, which has a higher proportion of shares in technology and health care.

Sharī'ah-compliant stocks constitute 36% of the assets of Islamic funds, and money market instruments 35%, while *sukūk* account for only 7%. The number of publicly available Islamic funds increased to 1220, but their assets under management (AuM) decreased so that the average size of an Islamic fund is rather small. Seventy-one per cent of the funds have AuM of less than USD25 million, meaning that a considerable number of funds do not reach the critical mass necessary for efficiency and sustainability. Funds could expand their size significantly if they were able, for example, to attract and manage assets of *awqāf* or Sharī'ah-compliant portions of pension schemes.

Three jurisdictions account for 84% of the global *takāful* contributions: Saudi Arabia (37%), Iran (34%) and Malaysia (14%). The structure of their *takāful* sectors differs fundamentally: while nearly two-thirds of the contributions are for family *takāful* (with a strong savings/investment component) in Malaysia, this business line is virtually non-existent in Saudi Arabia and Iran where non-Life (e.g. medical/health or motor) is dominant. The resilience of investment-linked family *takāful* is quite high, as investment risks are largely passed on to the *takāful* participants. Fierce price competition had undermined the resilience of general *takāful* in the past, but recent advances in solvency regulations and the expansion of compulsory motor and health insurance have improved its robustness.

A subsector of Islamic finance that is receiving growing public attention is Islamic microfinance (microcredit and microtakāful). Microfinance is less developed in Muslim countries than in the rest of the world, and Islamic microfinance is only a tiny portion of the overall microfinance sector even in Muslim countries. An exception is Sudan, where the entire financial system has been Islamised. The central bank actively promotes Islamic microfinance and has updated its comprehensive regulatory regime for the sector in 2015. In Bangladesh, the most comprehensive Islamic microfinance scheme has been established by the country's largest private bank. In contrast to the dominance of one institution in Bangladesh, Islamic microfinance is provided by a large number of institutions in Indonesia. Its cooperative model combines Islamic charity funds with Sharī'ah-compliant modes of financing. Over the last years, financial inclusion of individuals (meaning that they have access to a bank account) has increased worldwide, but Islamic countries are still lagging behind. There is no clear correlation between the market share of Islamic banks and the share of people who are unbanked for religious reasons.

Changes in the Global Financial Architecture

The global financial architecture is shaped by the Financial Stability Board (FSB), which has the mandate to identify and address vulnerabilities of the global financial system by regulatory, supervisory and financial-sector policies. Specialised standard setters cover the major sectors of the financial system: the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

The FSB has published several guidance papers and consultative documents that deal with special aspects of the "too-big-to-fail" issue and the resolvability of global systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs). G-SIBs and G-SIIs are presently not an issue for the IFSI, which also lacks experience with recovery and resolution. However, some institutions are likely to be domestically systemically important, and the Islamic Financial Services Board (IFSB) will deal with various aspects of insolvency, resolution and recovery in Islamic finance (with special attention to the treatment of investment account holders and *takāful* policyholders).

The Joint Forum of BCBS, IOSCO and IAIS published a report in June 2015 entitled, 'Developments in credit risk management across sectors: current practices and recoomendations'. The report outlined the increasing importance of credit from non-bank financial intermediaries, which has received little attention from Islamic finance regulators to date. Another finding was the difficulty in managing the credit risks of loans to small and medium-sized enterprises (SMEs) – a target group in Islamic financial inclusiveness initiatives. Sharī'ah requirements for risk mitigation techniques make SME credit risk management challenging for IIFS.

The BCBS has issued a number of standards and consultation documents that cover a wide range of topics, including: the securitisation framework; the capital treatment for simple, transparent and comparable securitisations; capital floors; the Standardised Approach for credit risk; and the minimum capital requirements for market risks. All these topics are related to IFSB-15: Revised Capital Adequacy Standard for IIFS, but they need to be addressed more specifically. The necessary amendments of and additions to IFSB-15 will be made in the context of a forthcoming revision. For Pillar 3 of Basel III, the BCBS has released revised disclosure requirements. An update of IFSB-4: Disclosures to Promote Transparency and Market Discipline for IIFS will include these revised requirements, plus a consumer protection dimension.

The IAIS further detailed its Insurance Capital Standard (ICS) by the adoption of a Higher Loss Absorbency Requirement for G-SIIs (in addition to the Basic Capital Requirements), but work on the ICS is ongoing. The IFSB will revise IFSB-11: Standard on Solvency Requirements for *takāful* (Islamic Insurance) Undertakings accordingly, but the revision will only begin after the ICS is nearing completion. However, the IFSB will commence a new research project on capital-related issues for the *takāful* sector this year that will cover aspects of surplus sharing, *Qarḍ*, etc. The IAIS also started a process of updating and amending the Insurance Core Principles (ICPs) that may continue for approximately two years. Once completed, the IFSB will refer to the ICPs when drafting a standard on Core Principles for Islamic Finance Regulation for the *takāful* segment.

The IOSCO has published several reports and analyses on topics that are also on the agenda of the IFSB: regulation of crowdfunding and of money market funds; timeliness and frequency of disclosure to investors; and prudential standards in the securities sector. All these topics are of interest to Islamic finance and are currently being observed by the IFSB.

Major Recent Initiatives by the IFSB

Based on the work of a Task Force for Stress Testing for IIFS, a Technical Note on Stress Testing will be finalised by the end of 2016.

Based on consultations of a working group and a survey of *retakāful* practices, a draft of a standard on Guiding Principles for *Retakāfu*l (Islamic Reinsurance) has been prepared. The five main principles cover the governance of *retakāful* undertakings, compliance with Sharīʻah principles, the prudential framework, transparency and disclosure, and the supervisory review of *retakāful* arrangements. The standard is targeted for finalisation by April 2016.

As preparation for the exposure draft of a standard on Guiding Principles on Disclosure Requirements for Islamic Capital Market Products, a survey was conducted. In most jurisdictions where *sukūk* or Islamic collective investment schemes (ICIS) are available, special regulations for Islamic products apply, but in some jurisdictions the regulations for Islamic and conventional capital market products are the same. The regulatory treatment of *sukūk* and ICIS is by no means unified. The Guiding Principles are intended to be applicable in different legal systems, as well as for cross-border transactions. The disclosure will comprise information not only on economic and financial aspects but also on Sharīʻah issues. The standard will cover *sukūk* and general ICIS, as well as specialised ICIS such as Islamic real estate investment trusts, Islamic exchange-traded funds and Islamic money market funds.

The IFSB undertook its fourth IFSB Standards Implementation Survey in 2015 to assess the implementation status of its standards, with a view to formulating its strategy to support the implementation process over the medium to longer term. The survey indicated measurable progress in the implementation of some standards in 2015 as compared to 2014. There has been a quick take-up of recently issued standards, such as IFSB-13, IFSB-14 and IFSB-15. Members are also familiarising themselves with and adjusting to the new standards and are desirous of more support.

The IFSB and IAIS published a joint paper on the regulation and supervision of *microtakāful*. The paper points out the need to clearly define the roles and responsibilities of all stakeholders (regulators, government agencies, *takāful* and *retakāful* operators, Sharīʻah boards, and participants), and to establish a cooperation mechanism. Regulators should look at the corporate governance of operators, consumer protection, solvency requirements, underwriting practices and funds management.

A Sharīʻah-compliant deposit insurance scheme (SCDIS) can be expected to promote the stability and resilience of the IFSI and prevent bank runs caused by a loss of confidence of depositors and investment account holders. The structuring of an insurance scheme for accounts based on muḍārabah contracts is challenging from a Sharīʻah perspective, but solutions have been found (often with a reference to *maqāṣid al*-Sharīʻah). In preparation for the production of a Working Paper, the IFSB conducted a survey and compiled for five jurisdictions the details of their SCDIS – in particular, the types of accounts protected, the underlying principle (*takāful* or *kafālah*), and the funding of the scheme. All schemes have peculiarities, and no two schemes are identical.

The IFSB conducted a survey on consumer protection in Islamic finance and asked regulatory and supervisory authorities (RSAs) about, among other things, their perception of the consumer-friendliness of Islamic financial products. Only half of the RSAs considered Islamic financial products more consumer-friendly than conventional ones. RSAs who considered Islamic financial products less consumer-friendly pointed to their complexity. For them, financial education, business regulation and product standardisation have priority, while RSAs that find Islamic products more consumer-friendly give priority to product standardisation, harmonisation of Sharīʻah compliance rules, and mandatory Sharīʻah governance systems on the level of the IIFS. The IFSB has already issued a Working Paper on Consumer Protection and Islamic Finance (WP-03) in late 2015.

The IFSB has also published a comparative study on the implementation of standards. One issue which is common to conventional and Islamic standards is that international standards are in parts not relevant for the level of development of financial regulation in a particular jurisdiction. Here, ways should be found to implement standards in accordance with local priorities. However, it was also observed that some RSAs have more difficulty in implementing IFSB standards than conventional standards. This may be due in part to issues of institutional capacity both in RSAs and in the industry. Another possible reason is that there is no general consensus in a jurisdiction that international standards in general, and IFSB standards in particular, will normally be implemented. Such a commitment, and the conviction that a standard will be implemented and obstacles will be overcome, are key to a successful implementation.

Emerging Issues in Islamic Finance

The Global Financial Crisis (GFC) showed the critical role that cross-border financial flows can play in transmitting and amplying shocks in one market to other financial markets and then to the global financial system. Analyses of the GFC produced new insights on cross-sectoral and cross-border transmission and contagion channels that are, in principle, also relevant for Islamic finance. However, sufficiently detailed data on cross-sectoral and cross-border transactions in the IFSI have not been collected systematically. Therefore, the chapter on cross-sectoral links between various sectors of the IFSI and the implications for systemic stability is only a first introduction to the topic. It offers a rough comparison of structures of conventional and Islamic finance and a few conclusions regarding systemic stability. The most important cross-sectoral links with potential relevance for systemic stability are those between Islamic banking and the Islamic capital market – in particular, the *sukūk* market. However, the small size of the *sukūk* market and the participation of conventional market players make it very unlikely that a crisis in the *sukūk* market could trigger a crisis in Islamic banking and hence induce a systemic crisis. A contagion from the much smaller *takāful* sector is even less likely. A peculiarity of Islamic finance that deserves further attention is Sharī'ah-related shocks, by which the legality or legitimacy of widespread practices in one sector are challenged. In theory, spill-overs to other sectors and a threat to systemic stability cannot be ruled out.

Regulations for anti-money laundering (AML) and countering the financing of terrorism (CFT) rank high on the political agenda. Global standards for AML/CFT have been developed and are monitored by the Financial Action Task Force (FATF) whose membership represents almost all major financial markets across the world. The compliance of its members with AML/CFT standards is monitored regularly by a peer review process. In most jurisdictions, the AML/CFT framework that was developed for conventional finance is also applied to IIFS without any amendment; only a few jurisdictions provide additional guidance to IIFS. The money laundering and terrorist financing risks faced by IIFS are not materially different from those faced by conventional finance. The fact that IIFS use different types of contracts does not facilitate money laundering in any way or expose IIFS to specific vulnerabilities. The often-criticised Hawala system is an informal money transfer system that operates independently of any banking system, including Islamic banking. Like conventional financial institutions, IIFS are obliged to ensure the integrity of their clients, the identity of ultimate beneficiaries, the nature and origin of funds received or paid, and the legality of the underlying business. Asset-backed financing by IIFS and Sharī'ah compliance reviews are additional layers of control.

The GFC laid bare regulatory gaps and failures. A wave of regulatory reforms in all sectors of the financial markets followed the crisis. The FSB identified the full and consistent implementation of regulatory standards within an internationally agreed time frame as an essential prerequisite for strengthening the resilience of the financial system. Therefore, the FSB and BCBS, IOSCO and IAIS launched a concerted programme to assess and ensure consistency and completeness in the implementation of global prudential standards. While this programme was designed for conventional finance, its basic ideas and approaches are also relevant for Islamic finance. The IFSB has studied in detail the processes and procedures of the BCBS's Regulatory Consistency Assessment Programme (RCAP) for banking, and the assessment and monitoring programmes of IOSCO and IAIS for capital markets and insurance, respectively. It is expected that the IFSB will develop its own assessment programme – for example, by thematic reviews on various issues such as risk-weighting of credit risk exposures in Sharī'ah-compliant products and contracts (including profit-sharing contracts), capital adequacy standards for *sukūk*, securitisations and real estate investments, and the treatment of profit-sharing investment accounts in the calculation of regulatory capital. A full RCAP for IFSB standards may follow at a later stage.

1.0 DEVELOPMENT OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 SIZE OF THE INDUSTRY AND SYSTEMICALLY IMPORTANT JURISDICTIONS

The global Islamic financial services industry reached an overall total value[1] of USD1.88 trillion as of 2015 YTD[2] (FSR2015[3] : USD1.87 trillion) (see Table 1.1.1), weathering a series of economic challenges ranging from prolonged low energy prices and downwardly revised economic growth outlook, to geopolitical conflicts, exchange rate depreciations and an assets sell-off spree in emerging markets. There was a marked change from the double-digit growth rates of recent years. In comparison to values reported in the previous IFSB Islamic Financial Services Industry (IFSI) Stability Report 2015, by sector, the global *sukūk* outstanding (based on par value at issuance) has declined by 1.4% to USD290.6 billion (FSR2015: USD294.7 billion), while Islamic funds' assets have contracted by 6.3% to USD71.3 billion (FSR2015: USD75.8 billion). In contrast, the *takāful* sector is estimated to have expanded by 8.4% to USD23.2 billion (FSR2015: USD21.4 billion), while the dominant Islamic banking sector has grown moderately at 1.4% to USD1.5 trillion (FSR2015: USD1.48 trillion). As will be analysed in detail in the following subsections, exchange rate depreciations in key Islamic finance markets (e.g. Iran, Malaysia, Turkey, and Indonesia) have been an important reason for the relatively modest performance of the global IFSI in US Dollar terms in 2015, particularly in the Islamic banking segment. Similarly, the withdrawal of a major issuer in the global *sukūk* market, leading to a substantial fall in primary market issuances in 2015, combined with overall downward pressures in the global equity markets, have featured as prominent reasons for asset value contractions in the Islamic capital markets. As an indicative comparison and in US Dollar terms, the assets of the top 1000 global conventional banks[4] had grown by 0.6% (y-o-y as of end-2014); the international debt securities outstanding in global markets[5] had declined by 1.3% (between end-2014 and 1H2015); and the premiums in the insurance industry are modestly estimated to have expanded by 2.0% (life insurers) and 2.5% (non-life insurers) in 2015.[6]

Table 1.1.1
Breakdown of Islamic Finance Segments by Region (USD billion, 2015 YTD*)

Region	Banking Assets	*Sukūk* Outstanding	Islamic Funds' Assets	*Takāful* Contributions
Asia	209.3	174.7	23.2	5.2
GCC	598.8	103.7	31.2	10.4
MENA (exc. GCC)	607.5	9.4	0.3	7.1
Sub-Saharan Africa	24.0	0.7	1.4	0.5
Others	56.9	2.1	15.2	–
Total	1496.5	290.6	71.3	23.2

**Data for banking and takāful as of 1H2015, while for sukūk and funds as of 11M15.*
Source: IFSB Secretariat Workings.
Note: Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.). Where primary data are unavailable, third-party data providers have been used, including Bloomberg, Zawya, EY and World Islamic Insurance Directory 2015. In only a few instances where there were still information gaps were data estimated based on historical growth trends and country-specific assumptions. Takāful contributions are used as a basis to reflect the growth in the takāful industry. The breakdown of Islamic funds' assets is by domicile of the funds, while for sukūk outstanding it is by domicile of the obligor.

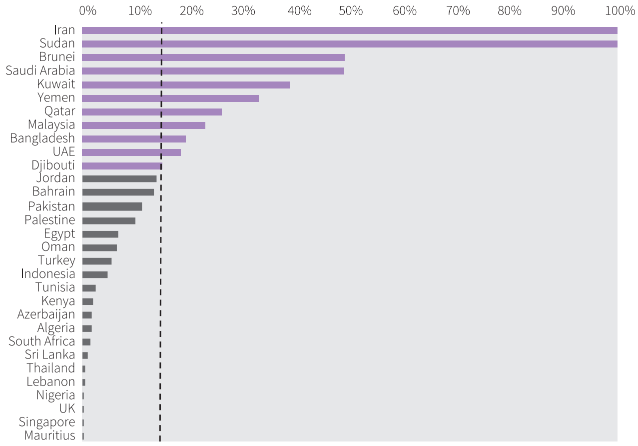
The number of jurisdictions where the IFSI has achieved systemic importance[7] has expanded to 11 in 2015, with the latest addition being Djibouti in Africa, where the share for Islamic banking in its total domestic banking sector exceeded 15%. Meanwhile, Iran and Sudan continue as the two jurisdictions that operate fully Sharī'ah-compliant banking systems; hence, a 100% Islamic banking market share for each. The share of Islamic banking in Brunei

[1] The figure quoted here is in fact a composite made up by adding assets in the banking sector and Islamic funds to the value of *sukūk* outstanding and to *takāful* contributions. The latter is a measure of income rather than assets, and elsewhere there may be elements of double counting – for example, if a bank holds *sukūk*. The figure is nevertheless the best measure we can offer in the current state of data availability.
[2] Data for the banking and takāful sectors are as of 1H2015, while for *sukūk* and funds data are as of 11M15. See Table 1.1.1 and its explanatory note for more details.
[3] FSR2015 = *IFSB IFSI Stability Report 2015.*
[4] Based on the "Top 1000 Banks" database maintained by The Banker.
[5] Based on the "Debt Securities Statistics" database maintained by the Bank for International Settlements.
[6] Swiss Re, *Global Insurance Review 2015* and *Outlook 2016/17.*
[7] This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report uses the Islamic banking segment as the criterion for systemic importance of Islamic finance, since about 80% of Islamic financial assets are held within the banking sector.

has increased substantially, to 49% in 1H2015 (FSR2015: 41%), bringing it to a level similar to Saudi Arabia, which is also estimated to hold a 49% share in 1H2015 (FSR2015: 51%). A substantial improvement in market share is also noted in Yemen at 33% (FSR2015: 27%), while Kuwait at 38.9% (FSR2015: 38%), Qatar at 26.1% (FSR2015: 25.1%), Malaysia[8] at 23.0% (FSR2015: 21.9%), Bangladesh at 19.4% (FSR2015: 17%) and the United Arab Emirates at 18.4% (FSR2015: 17.4%) have all improved on their market share compared to the previous year.

Overall, tracking a total of 31 jurisdictions (see Chart 1.1.1), 17 jurisdictions have experienced an increase in their domestic market share for Islamic banking in 1H2015 (compared to 1H2014), while eight others (including Iran and Sudan) have experienced constant market shares, and only three have experienced very marginal declines (Saudi Arabia, Turkey and the United Kingdom). In addition, three jurisdictions have newly been introduced into this tracking list: Palestine (which boasts a 10% market share for Islamic banking), Djibouti (at 15%) and Sri Lanka (at 1%).

Chart 1.1.1
Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2015)



**The countries in purple coloured bars indicate those that satisfy the criteria of having a more than 15% share of Islamic banking assets as a proportion of total domestic banking sector assets and, hence, are categorised as systemically important (see footnote 7).*
Source: IFSB Secretariat Workings (see the note in Table 1.1.1).

The concentration of assets in the jurisdictions classified as systemically important remains high, with 88% of the Islamic banking assets (or USD1.32 trillion) and 84% of the global *sukūk* outstanding (or USD245.4 billion) domiciled in these 11 jurisdictions (see Charts 1.1.2 and 1.1.3). Regionally, the GCC is the largest domicile for Islamic financial assets, accounting for 39.5% of the global IFSI (FSR2015: 37.6%). The next most important region is the Middle East and North Africa excluding GCC (MENA ex-GCC) with a 33.2% share (FSR2015: 34.4%), largely buoyed by Iran. The share of Asia is third, with a 21.9% contribution (FSR2015: 22.4%), mainly contributed by the likes of Malaysia, Indonesia, Pakistan and Bangladesh. The proportionate shares of MENA ex-GCC and Asia in US Dollar terms have fallen slightly in 1H2015 on account of exchange rate depreciations in their key Islamic finance markets. In contrast, the countries of the six-nation GCC practise fixed exchange-rate regimes, which enables them to sustain values in US Dollar terms.

Chart 1.1.2
Islamic Banking Assets in Jurisdictions with an Islamic Finance Sector of Systemic Importance (1H2015)

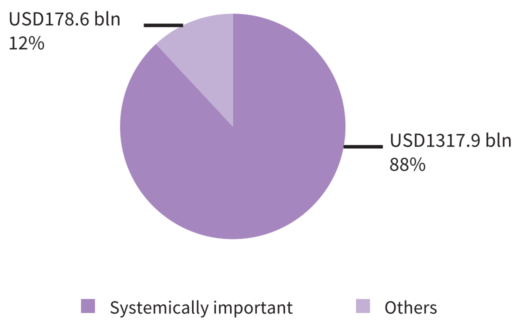
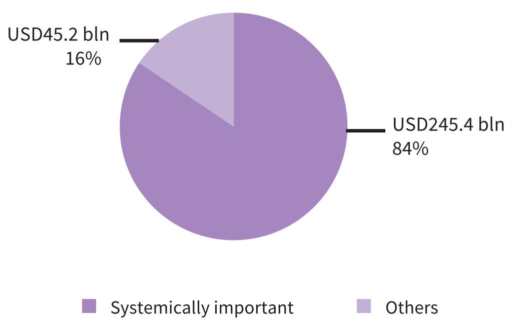


Chart 1.1.3
Sukūk* Outstanding in Jurisdictions with an Islamic Finance Sector of Systemic Importance (11M15)

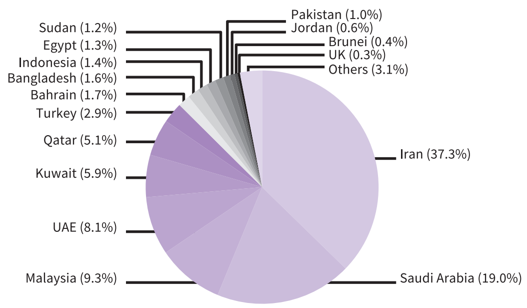


**Sukūk issuance domicile is based on the domicile of obligors.*
Source: IFSB Secretariat Workings.
Note: "Jurisdictions with an Islamic finance sector of systemic importance" refers to countries that have achieved at least a 15% market share for their Islamic banking sector in proportion to their total domestic banking sector assets.

[8] Based on Islamic banks regulated by the Central Bank of Malaysia and excluding development financial institutions (DFIs) regulated by the Ministry of Finance, Malaysia. The share for Islamic banking in Malaysia is over 25% if DFIs are also included in the banking sector pool of assets.

By jurisdiction, Iran continues to be the largest domicile for Islamic banking assets, accounting for more than 37% of the global Islamic banking industry (FSR2015: 40.2%). The GCC states of Saudi Arabia, the United Arab Emirates (UAE) and Qatar have increased their shares in global Islamic banking assets to 19%, 8.1% and 5.1%, respectively (FSR2015: 18.6%, 7.4% and 4.5%, respectively). The shares of Malaysia and Turkey have contracted slightly in 1H2015 in US Dollar terms to 9.3% and 2.9%, respectively (FSR2015: 9.6% and 3.2%, respectively). The shares of other countries in general have remained close to those reported in the previous stability report.

Chart 1.1.4
Shares of Global Islamic Banking Assets* (1H2015)



**The shares are apportioned in US Dollar terms.*
Source: IFSB Secretariat Workings.

In terms of market developments, Islamic banking services are poised to establish a footprint in Suriname (located on the north-eastern coast of South America), a first for Islamic finance in the South Americas and the Caribbean. A Suriname-based private financial institution has engaged the services of the Islamic Corporation for the Development of the Private Sector (ICD), an Islamic Development Bank (IDB) affiliate, to convert its operations to fully comply with Islamic laws. Islamic financial services are also expected to gain traction in the North African nation of Morocco following the parliament's approval of its Islamic banking law in January 2015 that will regulate Islamic financial products and allow local and foreign banks to set up units that comply with Sharīʽah principles.

In the Middle East, growth in Islamic finance is expected from Iran in 2016 as international sanctions are lifted; the resulting increase in business and economic activities, including oil production, will spur Islamic banking since Iran operates a fully Sharīʽah-compliant banking system. In addition, the Iraqi parliament has recently endorsed its Islamic Banks Law No. 43 of 2015, which is expected to come into force in 2016. The Law defines the incorporation and licensing requirements applicable to Islamic banks and details the activities which Islamic banks may and may not undertake.

In Europe, KT Bank (a subsidiary of Kuveyt Turk, in turn, the Turkish subsidiary of Kuwait Finance House) was established in Germany in July 2015 as a full-fledged Islamic bank with EUR45 million (USD49.6 million) of capital. This is the first Islamic bank in the Eurozone and offers products to both retail and corporate customers. KT Bank has also stated its intention to issue a EUR100 million (USD110.2 million) *sukūk* by 2017. The British government has continued its firm commitment to Islamic finance as the UK Export Finance, a government-backed export credit guarantee agency, has provided a guarantee to its first *sukūk*, specifically Dubai's Emirates Airline *sukūk*, which has raised USD913 million to fund aircraft purchases, including the Airbus A380s.

Overall, the global IFSI has been able to withstand recent international economic adversities and socio-political conflicts and to sustain its overall industry asset values in US Dollar terms. In the following subsections, growth and developments across the three key sectors of the global IFSI (Islamic banking, *takāful* and Islamic capital markets), as well as the financial inclusion and microfinance aspects of Islamic finance as a fourth sector, will be analysed in detail. These three key sectors of the global IFSI are further analysed from a stability and resilience perspective in Chapter 3 of this report.

1.2 ISLAMIC BANKING: DEVELOPMENT REVIEW[9]

The Islamic banking sector continues to be the dominant segment, accounting for almost 80% of the global IFSI; assets in full-fledged Islamic banks, subsidiaries and windows amount to approximately USD1.5 trillion as at 1H2015 (FSR2015: USD1.48 trillion). The aggregated average industry growth in US Dollar terms has been very moderate at 1.4% y-o-y, particularly on account of exchange rate depreciations in several key Islamic banking markets, including Iran, Malaysia, Indonesia and Turkey. For instance, the Turkish participation banking sector, which represents nearly 3% of the global Islamic banking assets, expanded by 15.1% y-o-y in 1H2015 in local currency terms; the comparative growth figure in US Dollar terms is, however, negative. Similarly, the growth in Malaysian Islamic banking assets, which represent more than 9% of the global industry, was over 16% between 1H2014 and 1H2015 in local currency terms, while the comparator US Dollar figure is also negative.

A more meaningful assessment is done by analysing the expansion of Islamic banking services in the domestic

[9] The figures reported in this section of the *IFSB IFSI Stability Report 2016* (FSR) may vary marginally from those reported in FSR2015 on account of differences between estimated figures as reported in FSR2015 and actual figures reported in FSR2016; exchange rate variations affecting reported values in USD terms between FSR2015 and FSR2016; and other factors.

market share of the various jurisdictions. In this regard, Chart 1.1.1 in the previous section indicated that 17 jurisdictions had experienced an increase in market share for Islamic banking between 1H2014 and 1H2015. Among these, the GCC jurisdictions have further strengthened the penetration of the Islamic banking sector; notably Oman, which in 2012 had been the most recent, and in fact the last, GCC entrant into Islamic banking. The share of Islamic banking in Oman has increased substantially, to 6.5% in 1H2015 (FSR2015: 4.35%), within a period of less than four years.

In the other GCC countries, as of 1H2015, the Saudi Islamic banking sector is nearly one-half of the domestic banking sector, accounting for 49% of the total banking sector assets; the other two major markets with large domestic shares are Kuwait and Qatar, with almost 39% and 26% shares, respectively. Bahrain now has a 13.5% share (FSR2015: 12.7%) for Islamic banking services in its domestic banking market and is gradually moving towards achieving domestic systemic importance based on the 15% benchmark. The Central Bank of Bahrain (CBB) has called upon the Bahraini Islamic banks to explore mergers in order to create institutions of size and achieve economies of scale. In the United Arab Emirates, where Islamic banks now have an 18.4% market share (FSR2015: 17.4%), the central bank this year has decided to include Sharīʹah-compliant securities in the range of instruments it accepts as collateral for accessing liquidity, as part of its efforts to promote efficient liquidity management in Islamic banks. Overall, the GCC Islamic banking sector is worth almost USD600 billion.

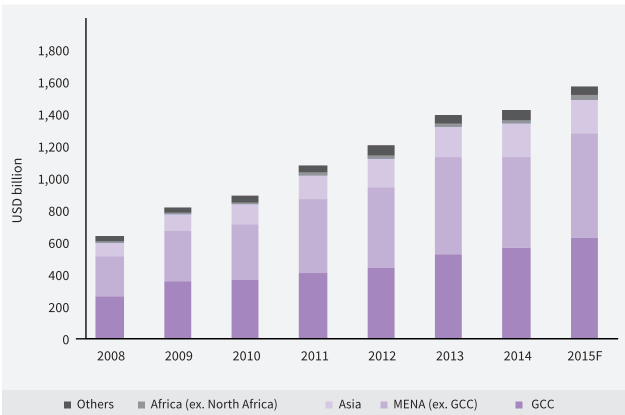
In Asia, the Malaysian Islamic banks have begun the segregation of investment accounts (structured on Sharīʹah contracts of *mushārakah*, *muḍārabah* and *wakālah*) from deposit accounts, with the former being prohibited from any form of principal and profit guarantees by the Islamic banks. This is required by the country's recent Islamic Financial Services Act 2013 (IFSA 2013) which introduces Sharīʹah contract-based regulatory framework that provides greater clarity of Sharīʹah rulings with regards to each Sharīʹah contract while also outlining operational requirements for the diversified IIFS product range. The regulatory implication of such is that investment accounts are risk-absorbing and hence the Islamic bank is not required to hold regulatory capital against assets funded by them. The market share of Islamic banks in the Malaysian banking sector has increased to 23% as of 1H2015 (FSR2015: 21.9%).

Pakistan is another jurisdiction where strong demand from the population, combined with facilitative regulatory support, is rapidly growing the country's Islamic banking sector; Islamic banking has now captured more than 11% of the domestic market share as of 1H2015 (FSR2015: 9.8%). The country's central bank expects the sector to reach 15% market share before 2018, and this would elevate the jurisdiction to being classified as having domestic systemic importance for Islamic banking. Jordan, in the Middle East region, is another jurisdiction that, with a 14% domestic market share in 1H2015 (FSR2015: 11.7%), is expected to be elevated to domestic systemic importance status by as early as 2016.

Elsewhere, Brunei has also achieved nearly 49% of the country's banking assets being Sharīʹah-compliant. In recent years, the country's financial system has been gradually transitioning into a Sharīʹah-compliant one, including offering both Islamic banking and *takāful* (Islamic insurance services). In addition, the country's central bank runs a regular *sukūk* issuance programme to support the liquidity management of the country's Islamic financial sector. Bangladesh is another jurisdiction that has consistently been gaining market share for Islamic banking services. As of 1H2015, the country's Islamic banking sector has achieved nearly a 20% domestic market share and the focus of the regulators is now moving towards developing Sharīʹah-compliant money market instruments.

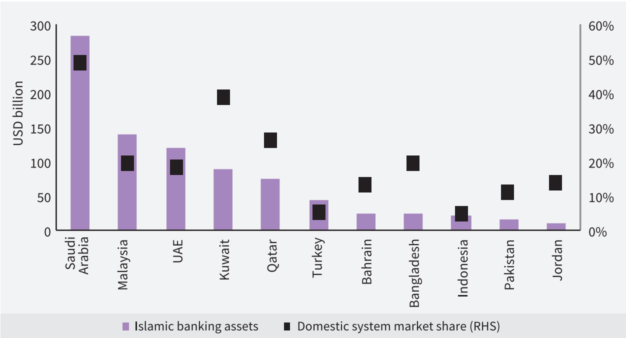
Islamic finance in the Sub-Saharan African region has been making inroads in recent years, with Islamic banking now being offered across many countries, including Kenya, Senegal, Niger, Nigeria and South Africa, among others. Islamic banking law and regulatory developments have also taken place in North Africa, particularly in Morocco and Tunisia. Morocco introduced a law in January 2015 to regulate Islamic financial products and allow local and foreign banks to set up units that comply with Sharīʹah. Furthermore, the law also allows for the formation of a centralised Sharīʹah board to oversee Islamic banks. The country's central bank, Bank Al-Maghrib, is currently reviewing applications for Islamic banking licences and the sector is expected to achieve a double-digit market share over the next ten years. Comparatively, Tunisia has two full-fledged Islamic banks, and the IDB-affiliate ICD is currently helping an additional leasing company to convert its operations into a full-fledged Islamic bank; the third for Tunisia.

Chart 1.2.1
Islamic Banking Assets Growth Trend (2008–2015F)



Source: IFSB Secretariat Workings.

Chart 1.2.2
Islamic Banking Assets and Market Share (1H2015)



Source: IFSB Secretariat Workings.

Overall, global Islamic banking assets are forecast to amount to approximately USD1.57 trillion by the end of 2015[10] (see Chart 1.2.1). However, there remains substantial asset concentration in a few Middle Eastern and Asian countries. The top ten Islamic banking jurisdictions by assets[11] account for 92.1% of the global Islamic banking industry (see Chart 1.1.4 in the previous section); this is a slight reduction in the concentration compared to the 94% assets concentration in 1H2014. Hence, the stability of the global Islamic banking system critically hinges upon the smooth functioning and viability of the Islamic banks in these ten jurisdictions alone.

In the following subsection, an overview[12] of the Islamic banking sectors' assets, financing and deposits growth patterns across 11 major Islamic banking domiciles (excluding Iran, due to data constraints) is presented using sample data from 59 prominent Islamic banks in these domiciles[13] (see Chart 1.2.2). The total assets of these sample banks amounted to USD672.2 billion as at 1H2015, which represents 71.6% of the total Islamic banking assets in 1H2015 (if Iran is excluded). These 11 markets include Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey and the UAE.

Islamic Banking Overview in Key Markets

The total Islamic banking assets across the sample 59 banks in 11 markets have expanded at a compound annual growth rate (CAGR) of 15.4% in the last six years (2008–2014). The growth has been moderating in recent years, as the CAGR in the last three years (2011–2014) has been at 13.8%, which compares with the 17.1% growth between 2008 and 2011 (see Chart 1.2.3). In particular, the y-o-y growth between 2013 and 2014 has just nearly managed the double-digit growth rate of 10% (see Chart 1.2.4). The slowdown in asset growth is attributable to a number of factors, with variations across countries (as analysed later), including the exchange rate depreciation in emerging markets (as growth is recorded in US Dollar terms), the slowdown in global economic growth performance and outlook, prolonged low energy prices in world markets, and generally weaker investor and consumer confidence in the global economy. There has been, however, some revival in 2015, as during the first six months the sample assets posted a 7.96% growth (non-annualised) and therefore, in 2015, asset growth is expected once again to sustain its double-digit rate.

Comparatively, the Islamic financing and deposit growth across the sample has fared better lately, with a 13.0% and 12.5% (respectively) y-o-y growth between 2013 and 2014. On a longer trend, the Islamic financing CAGR records 14.9% (2008–2014), while the deposit CAGR records 16.1% for the same period. Double-digit growth occurred even during the post-financial crisis years of 2008–2011, with Islamic financing at a CAGR of 14.3% and Islamic deposits at 17.6%. Nonetheless, in the latter period of 2011–2014 the Islamic financing CAGR has been at 15.6%, exceeding the Islamic deposit CAGR of 14.7% during the same period. This trend may be explained by a number of factors, including: (a) revival of financing by Islamic banks during the post-financial crisis years; and (b) newer Islamic banks expanding their financing portfolios following earlier periods when relatively greater focus was on deposits mobilisation. During the first six months of 2015, the Islamic financing growth across the sample posted a 6.1% growth (non-annualised), and hence this indicator is also expected to sustain a double-digit growth rate in 2015. Nonetheless, there were substantial variations in growth rates[14] when analysed across different countries.

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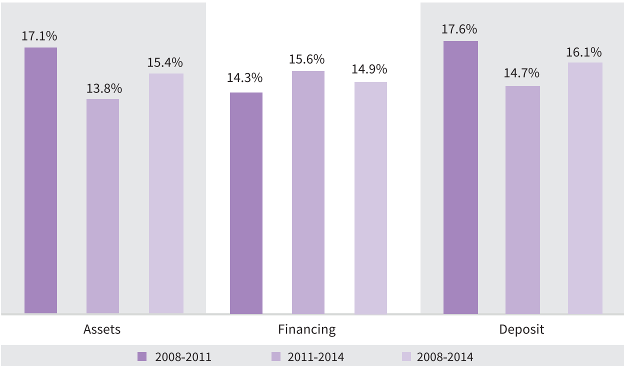
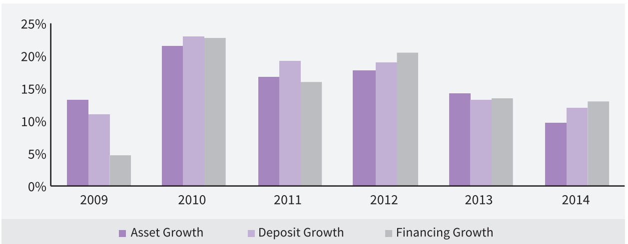
[10] The estimated figure for global Islamic banking assets as at end-2014 was reported as USD1.56 trillion in FSR2015. However, the actual figure for end-2014 is USD1.421 trillion, with many factors accounting for the change, including moderation in growth in the systemically important Islamic banking markets; the impact of emerging markets' volatilities on the financial system in those markets; and exchange rate depreciations leading to lower USD values of assets, particularly in countries such as Iran, Malaysia, Turkey, Indonesia and Pakistan, among others.
[11] This list comprises Iran, Saudi Arabia, Malaysia, the UAE, Kuwait, Qatar, Turkey, Bahrain, Bangladesh and Indonesia.
[12] A detailed and analytical review of the financial performances of the Islamic banking sector in these markets is presented in Chapter 3 of this report.
[13] The Islamic banking sample comprises full-fledged and subsidiary banks. The analysis excludes Islamic windows, as there are data limitation issues with regards to Islamic windows in most jurisdictions. Where data on Islamic windows are available, there is an issue of limited financial disclosure of Islamic windows as a separate business. The list of banks is presented in the appendix at the end of this report.
[14] The growth rates reported in the latter part of this subsection relating only to Charts 1.2.5 and 1.2.6, which analyse performance by individual countries, are based on data in local currency terms of the respective jurisdiction. The source data for these is the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFI) database.

Chart 1.2.3
Compound Annual Growth of Key Islamic Banking Statistics[15]



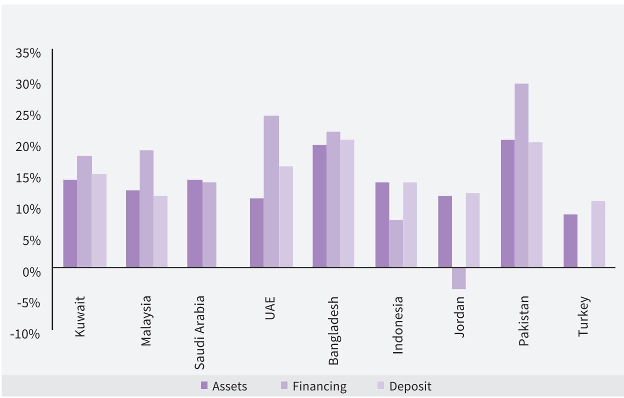
Source: Islamic banking sample, IFSB.

Chart 1.2.4
Islamic Banking Global Average Annual Growth Trends



Source: Islamic banking sample, IFSB.

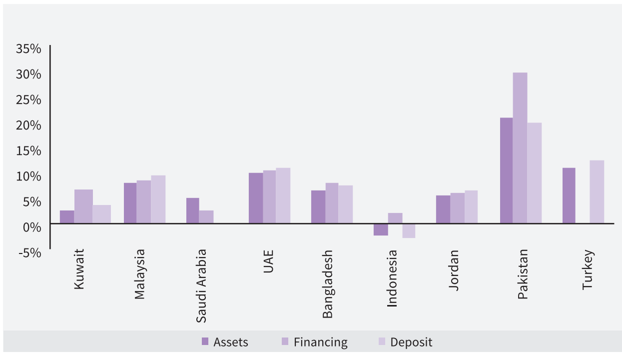
Chart 1.2.5
Islamic Banking Average Annual Growth by Country (2014)



Note: The growth rates in this chart for each country are calculated on data stated in local currency terms. There are some missing data points for Saudi Arabia and Turkey. The growth is annual, captured between end-2013 and end-2014.
Source: PSIFI, IFSB.

In general, growth rates were robust and at double-digit rates for most countries in the sample between 2013 and 2014 (see Chart 1.2.5); financing growth was particularly strong in Malaysia, the UAE, Bangladesh and Pakistan. The nearly 30% financing growth in Pakistan is spurred by a recent drive where conventional banks are actively pursuing Islamic banking opportunities by way of establishing Islamic subsidiaries or Islamic banking windows as well as pursuing full conversion of existing operations into Islamic ones. In Malaysia, the growth and expansion of Islamic finance is part of the broader government agenda where it targets a 40% share for Islamic financing in the country's banking sector by 2020. Growing awareness of Sharīʻah-compliant propositions and greater acceptance by the general public are key factors driving Islamic banking growth in the UAE and Bangladesh. In recent years, a number of conventional banks have started parallel Islamic banking operations through windows and subsidiaries in the UAE, although there are some concerns that the market is becoming overly competitive with too many suppliers. Jordan experienced a negative rate of financing growth in 2014, mainly biased by one major Islamic bank in the sample. The Turkish participation banking sector also made tremendous progress, and the development aggregates were biased in 2014 due to regulatory proceedings against one bank in the sample.

Chart 1.2.6
Islamic Banking Average Annual Growth by Country (1H2015)



Note: The growth rates in this chart for each country are calculated on data stated in local currency terms. There are some missing data points for Saudi Arabia and Turkey. Growth rates are non-annualised and captured for two quarters between end-2014 and 1H2015.
Source: PSIFI, IFSB.

In the first six months of 2015 (1H2015), there have been some downward pressures in the growth rates (see Chart 1.2.6); the Indonesian Islamic banking sector particularly has experienced contractions in both asset values and total deposits. The financing growth rates have also lowered relative to 2014 in most countries, including Saudi Arabia, Malaysia, the UAE, Bangladesh and

[15] The use of the term "deposit" in this section includes unrestricted profit-sharing investment accounts (UPSIAs), which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

Indonesia. Islamic banking asset growth slowdown is also evident in Kuwait in 1H2015. Turkey has experienced an improvement in its participation sector's growth in 1H2015 (relative to 2014), as its supervisory authority has completed the restructuring of the previously affected Islamic bank. Pakistan's Islamic banking sector, however, has continued its high expansion rate, achieving an additional 30% growth in financing (relative to end-2014 figure) within six months of 2015. Pakistan's economy is currently characterised by improving performance and favourable forecasts by the multilateral development banks.

In general, the Islamic banking sector's fundamentals are likely to experience a challenging close in 2015 while facing rising risks in 2016. Major international ratings agencies have warned of global macroeconomic conditions taking a toll on the liquidity and earnings of the banking sector (both Islamic and conventional) in jurisdictions classified as commodity exporting and emerging market. These macroeconomic challenges are also likely to slow deposit growth due to relatively weaker liquidity conditions, while asset quality is also at risk of deterioration in line with the economic slowdown. The latter increases the risk of credit losses and non-performing financing (NPF) for both conventional and Islamic banks. These Islamic bank fundamentals are further analysed in Chapter 3 of this stability report.

1.3 ISLAMIC CAPITAL MARKETS: DEVELOPMENT REVIEW

Although finishing with resilient performances towards the end of 2014, the three sectors of the Islamic capital markets (ICM) – namely, *sukūk*, Sharīʻah-compliant equity, and the Islamic funds market – have experienced some volatile movements and setbacks recently, including contractions in returns and asset values. This is akin to the trends observed in the global capital markets, particularly in those markets characterised as emerging, underpinned by a moderation in the global economic growth with risks shifting to the emerging markets and its associated macroeconomic rebalancing pressures. These factors, plus certain political decisions (see the effects of the Central Bank of Malaysia's policy in Chart 1.3.1.2 further below), have also impacted the growth momentum of the ICM in 2015.

The momentum, however, is not all negative, as the ICM continue to attract diverse investors and issuers from around the world. The issuer base of *sukūk* has once again expanded in 2015 with debut issuances by the Sultanate of Oman and Cote D'Ivoire in the sovereign sector, and a return of issuance by the World Bank's International Finance Corporation (IFC). Similarly, the number of publicly available Islamic funds across different asset classes of investments has increased by 59 to 1220 as of 10M2015. An additional change in 2015 has been in the composition of *sukūk* issuances volume by maturity, whereby the share of medium to longer-term *sukūk* (bearing maturities of three–five years and then longer than five years) has increased, although this shift is due mainly to a decline in short-term tenure *sukūk* issuances. The following subsections of this report analyse the growth and development trends of the ICM in 2015.

1.3.1 *Sukūk*[16]

The global *sukūk* outstanding reached an all-time high of USD300.9 billion as at end-2014, recording a resounding post-financial crisis double-digit CAGR of 19.56% between 2009 and 2014 (see Chart 1.3.1.1). This growth had been spurred by the heightened activity in the primary *sukūk* market where annual issuances had surpassed the milestone USD100 billion mark for three consecutive years between 2012 and 2014. Nonetheless, the decision by the traditionally largest *sukūk* issuer by volume, Bank Negara Malaysia (BNM, Central Bank of Malaysia), to stop its short-term liquidity management *sukūk* programme[17] has materially contracted the primary market issuances volume in 2015.[18] As of the 11 months ended November 2015 (11M15), the global primary *sukūk* market issuances amounted to nearly USD59 billion, with approximately 70.0% (or USD41.3 billion) of the funds raised by sovereign and government-related entity (GRE) issuers [2014: 80.1%, or USD95.2 billion], and the remaining 30.0% (or USD17.7 billion) by corporate issuers [2014: 19.9%, or USD23.6 billion] (see Chart 1.3.1.2). In turn, the global *sukūk* outstanding in 11M15 were valued at USD290.58 billion, a 3.4% contraction as compared to the record value as of end-2014. This drop in outstanding volume is attributable to a combination of factors, including a decline in issuances activity in 2015 as well as currency exchange rate movements where local currency *sukūk* outstanding are now valued lower in US Dollar terms.

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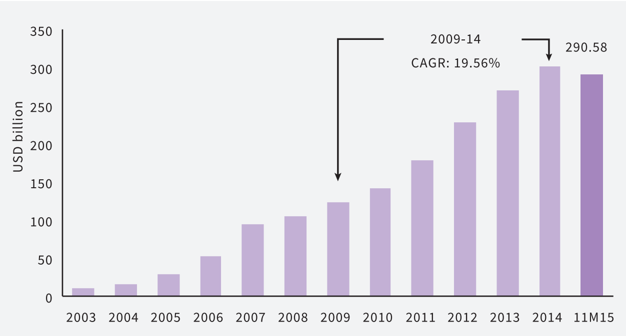
[16] *Sukūk* are certificates of investment in underlying assets, services or investment activities that generate fixed or floating returns according to Islamic principles. The instruments offer an alternative funding tool to conventional bonds that can be structured and utilised for a vast array of purposes. In recent years, *sukūk* products have seen significant innovation with the introduction of hybrid, convertible, perpetual, retail and regulatory liquidity/capital *sukūk*.

[17] It is understood that BNM has switched to other instruments for liquidity management that cater specifically to the Islamic banks it regulates; the previous *sukūk* programme was being subscribed to by a broad array of investors, preventing the *sukūk* from reaching their intended end-users (primarily Malaysian Islamic banks for liquidity management purposes).

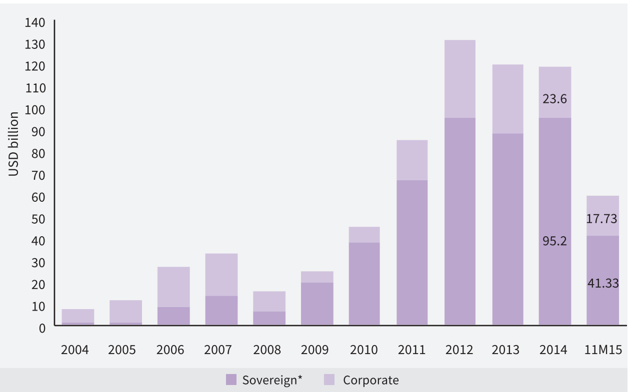
[18] The decline in values reported in US Dollar terms in this report is also partly attributable to the depreciation of many emerging market currencies (e.g. Malaysian Ringgits, Indonesian Rupiah, Pakistani Rupee and the Turkish Lira) against the US Dollar.

Chart 1.3.1.1
Global *Sukūk* Outstanding Trend (2003–11M15)



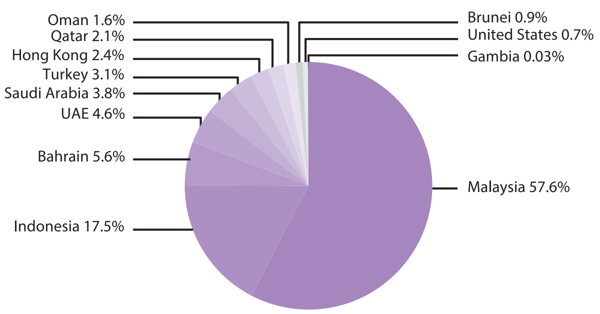
Source: Zawya, Bloomberg, IFSB.

Chart 1.3.1.2
Global *Sukūk* Issuances – Sovereign and Corporate (2004–11M15)



**Includes all GREs, multilateral development banks (MDBs) and international organisations (IOs).*
Source: Zawya, Bloomberg, IFSB.

Chart 1.3.1.3
Sovereign *Sukūk* Issuance by Jurisdiction* (11M15)



**Excludes Ivory Coast, as the proceeds for this sukūk have not been raised at the time of writing.*
@Includes all GREs, MDBs and IOs.
#MDBs and IOs include sukūk issuances by the IDB, the International Islamic Liquidity Management Corporation (IILM) and the World Bank (WB), and these have been traced to their headquarter jurisdictions, respectively (Saudi Arabia, Malaysia and the United States).
Source: Zawya, Bloomberg, IFSB.

Sovereign *Sukūk*

The global sovereign *sukūk* issuances volume in the primary market at USD41.3 billion is almost 57% lower (or USD53.9 billion less) in 11M15 as compared to 2014. This volume includes almost USD9 billion (or 21.8%) of liquidity raised through short-term *sukūk* (less than one year maturity) (2014: 56.9%). A notable issuer absent in 2015 has been the Malaysian central bank, which had issued nearly USD47 billion worth of *sukūk* in 2014. Despite this, sovereigns, GREs and international organisations domiciled in at least 13 jurisdictions have tapped the global sovereign *sukūk* market in 2015 (see Chart 1.3.1.3). Notably, the sovereign *sukūk* market witnessed the debut of the Sultanate of Oman in the GCC with the jurisdiction issuing an OMR250 million (USD650 million) five-year *sukūk al-Ijārah* in October 2015. The programme, originally intended as an OMR200 million issuance, had been upsized by the country's Ministry of Finance, following an oversubscription by 1.7 times with the order book amounting to OMR336 million. The Government of Oman's objectives for this debut sovereign *sukūk* issuance included offering investment avenues for Islamic banks, Islamic funds and *takāful* operators in Oman to deploy their excess funds in a Sharī'ah-compliant manner in the country, and to support the development of the capital market in Oman. The Ministry also announced that it intends to follow up with a repeat issuance in 2016.

On a different continent, Ivory Coast (Cote D'Ivoire) has become the latest African state to tap into the sovereign *sukūk* market as it launched its debut five-year sovereign *sukūk* programme worth XOF150 billion[19] (USD250 million), priced at a profit rate of 5.75%. The *sukūk* is being arranged by the Islamic Corporation for the Development of the Private Sector, an IDB affiliate, and the proceeds will be raised to finance development projects in Ivory Coast. This is the second West African sovereign *sukūk* following the debut by the state of Senegal in 2014 with an XOF100 billion four-year *sukūk al-ijārah* issuance.

Among the traditional issuers, despite BNM's absence, Malaysia has maintained its position as a key issuer, accounting for more than half of the sovereign *sukūk* volume in 2015 (11M15: USD23.8 billion; 2014: USD64.3 billion). The issuances were led by the government's medium- to long-term fund-raising *sukūk* issuances, as well as by several GREs, including oil-giant Petronas, infrastructure building entity Dana Infra, and the country's sovereign wealth fund, Khazanah Nasional Berhad. The issuances raised funds across three currencies: the US Dollar, the Singaporean Dollar and the Malaysian Ringgit.

The Indonesian government, through its Ministry of Finance, has expanded its issuance volume in 2015

[19] XOF = West African CFA Franc. It is the currency of eight independent states in West Africa: Benin, Burkina Faso, Guinea-Bissau, Ivory Coast, Mali, Niger, Sénégal and Togo.

(11M15: USD7.22 billion; 2014: USD6.37 billion). Most notably, the Government of Indonesia issued its largest *sukūk* transaction to date, a USD2.0 billion ten-year *sukūk*, which is also the largest-volume *sukūk* in a single transaction for the year 2015. The remaining issuances included local-currency *sukūk* of diverse types, including long-term project financing *sukūk*, short-term capital and liquidity management *sukūk*, as well as retail *sukūk*, partly intended to mobilise national savings from retail customers.

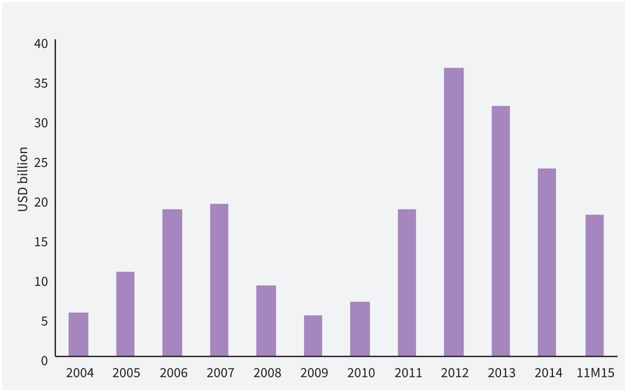
Other notable sovereign issuances included Hong Kong's repeat USD1.0 billion five-year *sukūk* issuance, its second following its debut issuance of the same amount and tenure in 2014. The Turkish Treasury also tapped the sovereign *sukūk* market twice in 2015, although notably raising funds only in local currency and not offering a repeat US Dollar tranche (11M15: USD1.29 billion; 2014: USD2.42 billion). Elsewhere in the GCC, the Qatari Central Bank floated four local-currency *sukūk* of different maturities worth USD858.65 million (2014: USD4.12 billion); in the UAE, the Government of Ras Al-Khaimah and the Dubai government-linked Emirates Airline each issued ten-year US Dollar instruments, raising a combined USD1.91 billion (2014: USD2.9 billion). Finally, the central banks of Bahrain, Brunei and The Gambia continued their short-term liquidity management *sukūk* programmes worth USD2.33 billion, USD377.1 million and USD13.4 million, respectively, in 11M15 (2014: USD2.38 billion; USD701.8 million; USD41.5 million).

Among the multilateral development banks and international organisations, the World Bank's IFC returned to the *sukūk* market with a five-year USD100 million *sukūk al-wakālah* issuance in September 2015; the IFC's previous *sukūk* outstanding with the same amount and maturity had matured in November 2014. The WB, in its capacity as the Treasury manager, also arranged a second *sukūk* for the UK-based International Finance Facility for Immunisation (IFFIm) worth USD200 million on a three-year tenure, compared to 2014's tranche, which was a five-year USD500 million issuance. The Saudi-based IDB also continued its annual *sukūk* issuance programme and issued a total of four instruments worth a combined USD1.56 billion in 11M15 (2014: USD4.1 billion). Notably, three of these instruments raised funds in Euro, as part of IDB's currency diversification initiatives in its funding profile. Finally, the Malaysia-based IILM expanded its programme, as it issued USD6.4 billion in 11M15 (2014: USD5.8 billion).

Corporate *Sukūk*

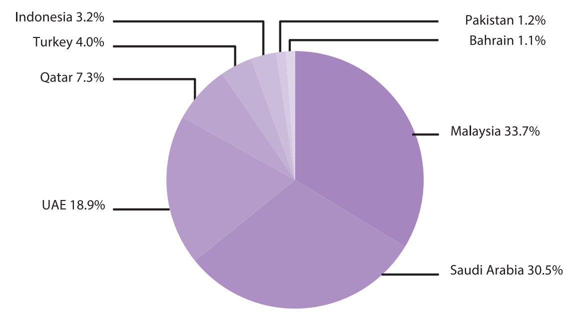
The global corporate *sukūk* issuances amounted to USD17.73 billion as of 11M15 (2014: USD23.6 billion). The issuances of fixed-income instruments (*sukūk* and conventional bonds) have generally eased in recent years starting with the US Federal Reserve's first indications in mid-2013 and eventual decision in early 2014 to gradually begin scaling back its quantitative easing (QE) programme; this has been followed in 2015 with socio-political and macroeconomic challenges in various regions of the global economy, leading to subdued economic growth forecasts. More recently, the sentiments are combined with expectations of interest rate increases in international markets (see Chart 1.3.1.4). Despite these challenges, corporate issuers across eight jurisdictions have tapped the *sukūk* market in 11M15 (see Chart 1.3.1.5).

Chart 1.3.1.4
Global Corporate *Sukūk* Issuances (2004–11M15)



Source: Zawya, Bloomberg, IFSB

Chart 1.3.1.5
Corporate *Sukūk* Issuance by Jurisdiction* (11M15)



**Based on obligor's domicile.*
Source: Zawya, Bloomberg, IFSB.

The activity in Malaysia is the largest in terms of volume by country, accounting for nearly 33.7% (or USD5.98 billion) of all corporate *sukūk* issued in 2015 (up to 11M15; 2014: USD13.6 billion). The Malaysian corporate issuers hail from very diverse sectors: agriculture, telecommunications, retail, real estate, financial services, health-care services and transportation. Among these have been two perpetual *sukūk* issued by a real estate company and a financial services provider. The issuances have been across a wide variety of maturities (ranging from one month to 21 years) and utilising the local currency as well as the US Dollar.

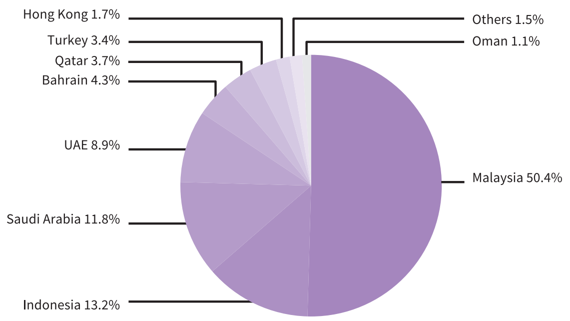
In contrast, corporate *sukūk* issuers in the GCC have predominantly been financial services providers, and almost all *sukūk* issuances in the region are either for a five-year or ten-year maturity, reflecting the limited activity in the GCC market for longer-maturity *sukūk*. Three exceptions for maturity profiles, one each in Saudi Arabia, Qatar and the UAE, have been perpetual Additional Tier-1 (AT1) *sukūk* issued by Islamic banks in these countries. Apart from the financial services sector, other issuers have included construction, food and beverage, transportation, real estate and retail. Nonetheless, the aggregate volumes of corporate *sukūk* issued in individual countries across the GCC have increased in 2015 (up to 11M15), led by Saudi Arabia (11M15: USD5.41 billion; 2014: USD4.01 billion), followed by the UAE (11M15: USD3.35 billion; 2014: USD2.82 billion), Qatar (11M15: USD1.30 billion; 2014: Nil) and Bahrain (11M15: USD200 million; 2014: Nil); there were no corporate issuances in Oman and Kuwait in 2015.

Among the remaining countries, the Turkish corporate *sukūk* market was also only tapped by Islamic banks in the local currency and for maturities up to five years, raising cumulatively over USD714 million (2014: USD1.7 billion). In Pakistan, there was only one corporate *sukūk* issued in the local currency for seven years, worth USD215.9 million, by a power and utilities provider (2014: USD61.2 million). Finally, in Indonesia, corporate issuers raised cumulatively USD569.1 million (2014: USD72.6 million) with the instruments' maturities ranging between one and ten years. Among the Indonesian issuances was a USD500 million *sukūk* issued by Garuda, the country's national airline. The other issuers included an Islamic bank and the national telecommunications company.

Overall Analysis

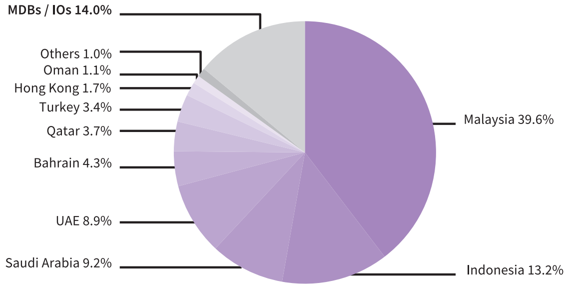
Overall, combined corporate and sovereign *sukūk* issuances activity in 2015 (up to 11M15) took place across 14 jurisdictions (2014: 19 jurisdictions). Malaysia has retained its position as the largest issuer of *sukūk* in terms of volume (see Chart 1.3.1.6(a)), accounting for 50.4% (or USD29.8 billion) of the issuances in 2015 (up to 11M15) (2014: 65.6%). Second was another Asian domicile, Indonesia, which accounted for an increased 13.2% (or USD7.8 billion) of the issuances in 2015 (up to 11M15) (2014: 5.3%). The GCC jurisdictions of Saudi Arabia, the UAE and Bahrain complete the top five in 2015 (up to 11M15), with share issuances of 11.8% (2014: 9.9%), 8.9% (2014: 4.8%) and 4.3% (2014: 2.0%), respectively. Collectively, the GCC region accounted for 29.8% (or USD17.6 billion) of volume in 11M15 (2014: 20.2%); Kuwait is the only GCC domicile that did not witness any *sukūk* issuance in 2015. The *sukūk* market was also tapped by issuers originating in two non-Organisation of Islamic Cooperation (OIC) member states, namely Hong Kong and the United States (by the World Bank). Among the jurisdictions where the previous year's issuers did not tap the market in 11M15 are Luxembourg, Maldives, Mauritius, Senegal, South Africa, Singapore and the United Kingdom.

Chart 1.3.1.6(a)
***Sukūk* Issuances by Domicile and Share (11M15)**



Source: Zawya, Bloomberg, IFSB.
Note: Domicile is the location of the obligor.

Chart 1.3.1.6(b)
***Sukūk* Issuances [ex-MDBs and IOs] by Domicile and Share (11M15)**



Source: Zawya, Bloomberg, IFSB.
Note: Domicile is the location of the obligor.

Excluding the share of issuances by MDBs and IOs, the above ranking of jurisdictions by volume is not materially altered (see Chart 1.3.1.6(b)). The share of Malaysia is the largest at 39.6% (or USD23.4 billion) after excluding issuance volume attributable to the IILM, while Saudi Arabia also retains third place with a 9.2% share (or USD5.4 billion) after excluding issuance volume attributable to the IDB. Nonetheless, MDBs and IOs are important issuers in the global *sukūk* market as they collectively issued an aggregate of USD8.3 billion worth of *sukūk* in 2015 (up to 11M15), accounting for 14.0% of the primary market.

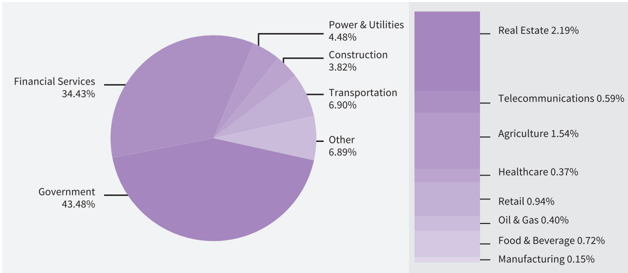
Analysing the *sukūk* market by sector (see Chart 1.3.1.7), the proportion of funds raised by the financial services industry has further expanded, accounting for almost 34.5% of the volume in 11M15 (2014: 21.8%; 2013: 9.8%). This increase is due partly to increased regulatory capital and liquidity *sukūk* issued by IIFS, and to steady issuances by the MDBs and IOs (IILM, IDB and WB) who are all considered as financial services institutions. However, the surge is also the result of a substantial fall in the government sector (consisting of issuances by sovereign states, central banks or ministries of finance) which accounts for 43.48% of total issuances by volume in 11M15 (2014: 60.5%). Other sectors included transportation at 6.9% (2014: 2.2%), and power and utilities at 4.48% (2014: 6.45%). Particularly in the transportation sector, two airlines from the UAE and Indonesia, respectively, tapped the market to raise funds. The retail sector saw funds being raised by a children's clothing manufacturer and a gold and jewellery retailer in Malaysia, as well as by a big retail conglomerate in the UAE. The real estate and construction sector *sukūk* were mainly issued in Malaysia, and one in the UAE, while Saudi Arabia issued food and beverage sector *sukūk*.

In a shift of trend, the maturity profile of *sukūk* issued in 11M15 is increasingly in the five–ten years maturity bracket (11M15: 38.8%; 2014: 19.7%), followed by the three–five years bracket (11M15: 21.8%; 2014: 15.7%). This is in stark contrast to the trend in the last five years, where working capital and liquidity management *sukūk* of less than one year represented nearly 50% of the total issuance volume per year, on the back of strong issuances from the Central Bank of Malaysia (see Chart 1.3.1.8).

Finally, in terms of the secondary market returns performances of *sukūk* instruments, yields have experienced considerable volatility during the course of 2015, on account of a number of global, regional and national factors. On the global front, the meetings of the US Federal Reserve's Open Market Committee (FOMC) were closely followed by investors in anticipation of possible US interest rate increases. Towards the end of 2015, with increased expectations of a US interest rate increase, yields on US Dollar *sukūk* instruments have generally increased year-on-year across various jurisdictions (see Chart 1.3.1.9).

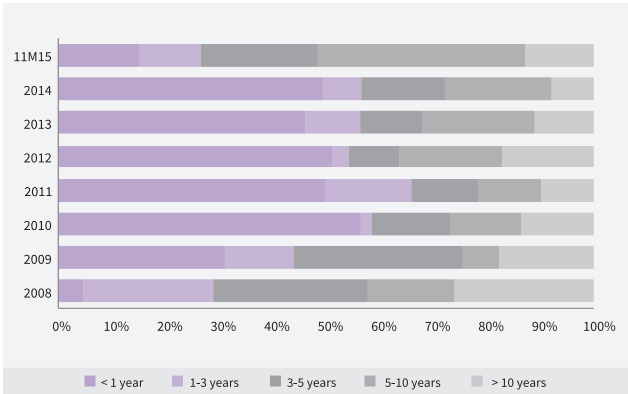
On a regional level, the emerging markets sell-off has continued into 2015, the trend pushed forward by an improving US economy and depreciations in emerging market currencies. This has led to foreign investors offloading local-currency bonds and *sukūk* in favour of US and other "safe-haven" currency-denominated Treasury and government securities. In addition, some prominent issuers of *sukūk*, notably Bahrain, Saudi Arabia and Turkey, have seen a rise in the yields expected for both bond and *sukūk* instruments, as a result of macroeconomic pressures and other jurisdiction-specific factors. This point is explored further in Chapter 3 of this report.

Chart 1.3.1.7
***Sukūk* Issuances by Sector (11M15)**



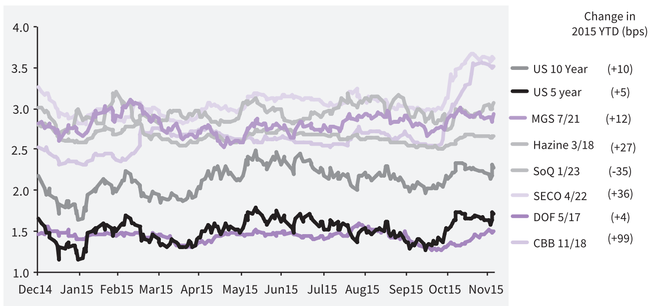
Source: Zawya, Bloomberg, IFSB.

Chart 1.3.1.8
***Sukūk* Maturity Trend of New Issuances**



Source: Zawya, Bloomberg, IFSB.

Chart 1.3.1.9
Selected USD *Sukūk* Yields vs US Government Securities Yield



Source: Bloomberg, IFSB.
Note: CBB = Central Bank of Bahrain, DOF = Dubai Department of Finance, SECO = Saudi Electricity Company, SoQ = State of Qatar, Hazine = Hazine Mustesarligi [Turkish Under Secretariat], MGS = Malaysia Global Sukūk Wakālah, US 5Y = US 5-Year Generic Government Yield, US 10Y = US 10-Year Generic Government Yield.

Summary, Outlook and Challenges

In summary, the *sukūk* sector has experienced a reduction in issuances activity and outstanding volume in 2015. The fundamental reason for this drop is the withdrawal of Bank Negara Malaysia as an issuer of short-term liquidity management *sukūk* in the Malaysian market. Furthermore, the depreciation of many emerging market currencies vis-à-vis the US Dollar is a contributing factor, as the local-currency issuances and outstanding volumes are now valued lower in US Dollar terms in comparison to the previous year. In the corporate sector, a combination of lower economic growth forecasts, expected rate increases by the US, and (in general) a weaker investor and consumer sentiment has contributed to a decline in issuances activity in 2015. This trend is also observable in the conventional bond market, where the international debt securities outstanding in global markets[20] has declined by 1.3% (between end-2014 and 1H2015). Nonetheless, the *sukūk* sector is witnessing an expanding number of business groups utilising the Sharīʻah-compliant instrument to raise funds; in 2015, debut corporate issuers have included, among others, an international airline in Indonesia, a children's clothing and accessories manufacturer in Malaysia, and a major retail conglomerate in the UAE. In addition, financial services providers have increased their issuances of revised regulatory-compliant capital adequacy *sukūk* to meet new international standards for banking-sector capitalisation.

The sovereign *sukūk* sector is expected to gain momentum in the near future on the back of increased budget deficit projections in several jurisdictions, particularly the energy-exporting countries where lower global energy prices have widened the budget deficits. For instance, in 2015, initial estimates have suggested a budget deficit of almost USD98 billion in Saudi Arabia, approximately USD34 billion in the UAE, USD27 billion in Kuwait[21] and USD6.5 billion in Oman. Kuwait, where no *sukūk* were issued in 2015, has witnessed the release of new rules by its Capital Market Authority covering issuance of *sukūk* in an attempt to invigorate the infrequent domestic *sukūk* market and facilitate sales of *sukūk* by both public- and private-sector entities. The Sultanate of Oman, following the success of its debut issuance in 2015, is expected to continue its sovereign programme going forward with repeat issuances, as announced by its Ministry of Finance, at least for 2016. Similarly, in Europe, the Grand Duchy of Luxembourg has also announced plans to repeat a sovereign *sukūk* issuance in 2016, following its successful debut in 2014.

In Africa, Cote D'Ivoire has become the second West African state to issue *sukūk* in 2015, and a number of other countries on the continent remain in the pipeline, including Tunisia, Morocco, Nigeria, Niger, Kenya and Egypt. In Central Asia, the Government of Kazakhstan is expected to issue a debut sovereign *sukūk* in 2016, following the approval in November 2015 by the country's parliament of legislative amendments to facilitate Islamic finance and issuance of sovereign *sukūk*. The Government of Jordan is also expected to issue a debut sovereign *sukūk* soon,[22] to finance projects of the Jordan Water Authority and purchases of the state-owned National Electric Power Company.

The regular issuers, including Malaysia, Turkey and Indonesia as sovereigns and the IDB and IILM as MDBs/IOs, have continued their programmes in 2015 and are likely to follow up with repeat issuances in 2016. Among the non-OIC member jurisdictions, the Government of Hong Kong returned with a repeat sovereign issuance in 2015 along with two issuances by the US-headquartered World Bank – among which is one repeat issuance for IFFIm for which the WB acts as the Treasury manager.

The challenges in the *sukūk* market remain broadly similar to those reported in the previous year's stability report. A combination of differing Sharīʻah opinions on *sukūk* tradability (whether only at par values or not for *sukūk* backed by a combination of debt/receivables and real assets and what are the acceptable thresholds for this composition before an instrument is deemed tradable) and use of credit enhancements (e.g. the use of repurchase undertaking and liquidity facilities in *mushārakah* and *muḍārabah sukūk*), as well as the general propensity of the investors to hold *sukūk* instruments until maturity, have restricted the liquidity and depth of the *sukūk* secondary markets. However, to overcome the issues surrounding tradability and use of credit enhancements, the issuances, at least in the international market,[23] are broadly moving towards adopting more harmonised and standardised *sukūk* structures that are generally agreed upon globally. For instance, most of the international *sukūk* issued by sovereigns and MDBs are consistently structured as *sukūk al-ijārah*, given its generally agreed-upon (by most Sharīʻah scholars globally) structure and secondary market tradability. In 2007, more than 40% of the primary market volume was raised through *sukūk* structured on *mushārakah* and *muḍārabah* contracts; in the last three years, the share of these *sukūk* has been less than 10%, while those structured on *ijārah* and *wakālah* have gained prominence in the international markets.

There has also been some progress made in terms of *sukūk* market infrastructure and its ancillary services.

[20] Based on the Debt Securities Statistics database maintained by the Bank for International Settlements (BIS).
[21] Reuters: Kuwait's parliament on 1 July 2015 approved the country's budget for the fiscal year from 2015 to 2016, forecasting a deficit of KWD8.18 billion (USD27 billion).
[22] As at the time of writing of this report.
[23] That is, *sukūk* listed on exchanges and available to cross-border investors.

Sukūk are now being rated by both international ratings agencies as well as domestic agencies in countries where available; this has enabled a better pricing mechanism for the investors. However, in terms of benchmark pricing itself, there is a disparity in progress; some countries have launched regular sovereign issuance programmes across wide maturities, which helps to provide the benchmark for pricing of various *sukūk* instruments; in others, the absence of a yield curve remains a problem and, combined with a thin and infrequent secondary market, *sukūk* issuances in these countries still continue to attract premiums (higher cost for issuers) as compared to comparable bond issuances. The same disparity is also prevalent from a legal perspective; some jurisdictions have a well-developed and accommodative legal framework that accords the required necessities for *sukūk* instruments (e.g. tax neutrality on underlying assets sale and purchase) to have a level-playing field vis-à-vis bonds; in others, particularly the new, niche and non-frequent Islamic finance domiciles, such issues are still prevalent.

From a broader macroeconomic perspective, the greater use of fixed-rate contracts and less frequent use of equity-based/risk-sharing principles (see Chart 3.4.6 in Chapter 3) to structure *sukūk* has attracted some criticism that there is a lack of differentiation between bonds and *sukūk*. Hence, *sukūk* are prone to all the same vulnerabilities and risks as are conventional bonds. Nonetheless, in general, *sukūk* instruments have gained considerable familiarity and acceptance globally as economically viable alternative fund-raising/investment instruments and are widely being tapped into by issuers and investors. Of late, the new trend has been first experiments with "social" and "green" *sukūk* (such as the immunisation *sukūk* by IFFIm), which could give *sukūk* a new direction towards more ethical finance. These factors and *sukūk* market challenges are discussed further in Chapter 3 of this report, which assesses the resilience of the different sectors of the Islamic financial services industry, including the *sukūk* market.

1.3.2 Islamic Equity Indices and Funds

In contrast to the *sukūk* market where alternative instruments are issued, the Islamic-listed equity securities are a subset of the broader global stock-market securities that undergo defined screening criteria to assess their compliance with Sharī'ah principles, and hence their suitability to be considered as Sharī'ah-compliant. Therefore, the volatilities and pricing movements in global stock markets also have an effect on securities categorised as Shari'ah-compliant. The Sharī'ah screening attempts to exclude those securities that contravene Sharī'ah principles (e.g. Riba, Gharar, Maysir, Haram business activities, etc.). Thus, the universe of Sharī'ah-compliant equities is smaller than that of conventional securities. Nevertheless, in recent years it appears that Sharī'ah-compliant equity indices have outperformed their larger conventional peers, largely due to their different sectoral composition; a quick analysis of two major equity indices, one Islamic and the other a comparable conventional index, appears to confirm this (see Chart 1.3.2.1 and Table 1.3.2.1).

Box 1.3.2.1
A Typical Sharī'ah Screening Process

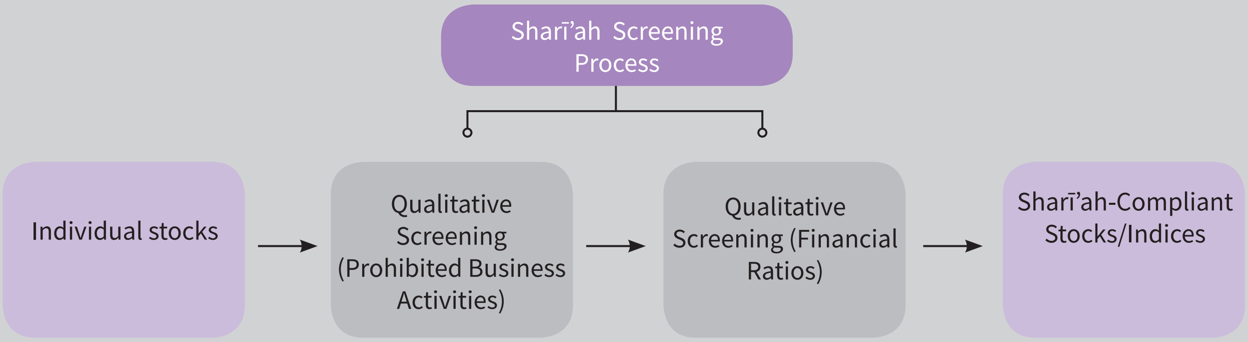
A typical Sharī'ah screening process will involve two stages (see Diagram 1.3.2.1.1):

1. A qualitative screening process which excludes companies whose core business activities are not compliant with Sharī`ah (e.g. conventional bank, alcohol brewery).

2. A quantitative screening process to detect companies whose financial practices are repugnant to Sharī'ah (e.g. interest income ratio). This process also screens companies that operate mixed activities, both permissible and non-permissible (e.g. a supermarket selling alcohol). The quantitative process identifies the contribution of the non-permissible activities to the total business, and this is compared with pre-established thresholds. A breach of the threshold will deem the security non-compliant, and vice versa. Different screening agencies/ institutions have different criteria.

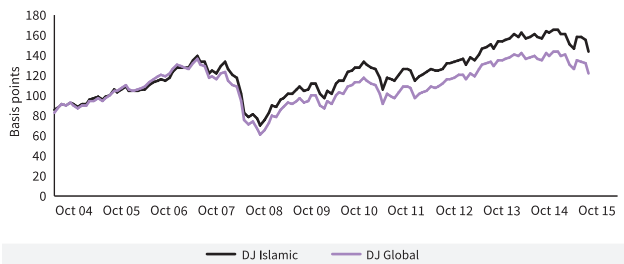
The screenings are done by the major global financial index providers, such as Dow Jones, Standard & Poor's, FTSE, MSCI and Russell Investments, or may also be done at the national level by the country's regulator (e.g. the Securities Commission of Malaysia's Sharī'ah Screening Methodology). Apart from these, screening may also be done by financial institutions, fund managers, specialist Sharī'ah firms, research houses, brokerage houses and even the exchanges themselves. A matter of critical importance, however, is to transparently disclose the screening criteria applied, for the knowledge and awareness of stakeholders.

Diagram 1.3.2.1.1 Typical Sharī'ah Screening Process



Source: IFSB.

Chart 1.3.2.1
Historical Performance of Dow Jones Global Index vs Dow Jones Islamic Market World Index



**The two indices are standardised at a scale of 100 for comparative purposes.*
Source: Bloomberg, IFSB.

Table 1.3.2.1
Total Returns of Dow Jones Global Index vs Dow Jones Islamic Market World Index

	Dow Jones Global Index	DJIM World Index
2015 (YTD)	-4.23%	-3.08%
3 Yr	23.5%	25.7%
5 Yr	32.8%	37.6%
10 Yr	37.5%	59.9%

**As of 7 December 2015.*
Source: Bloomberg, IFSB.

Analysing the 2015 YTD returns, as well as the total returns over a three-year, five-year and ten-year horizon, DJ Islamic has outperformed DJ Global. In particular, over the ten-year horizon, which includes the GFC period, the DJIM World Index has generated 22.4% higher total returns than those generated by the Dow Jones Global Index. During the stock-market downturn in 2015, the DJIM World Index has suffered 1.15% less loss in returns as compared to the Dow Jones Global Index. DJ Global has a substantially larger number of components and a higher market capitalisation than DJ Islamic (see Charts 1.3.2.2 and 1.3.2.3).

Chart 1.3.2.2 Number of Components (11M15)

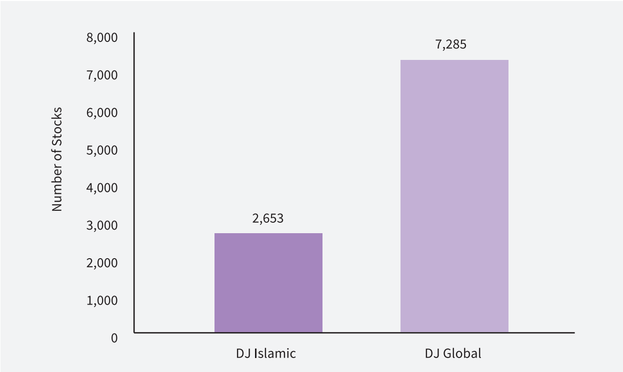
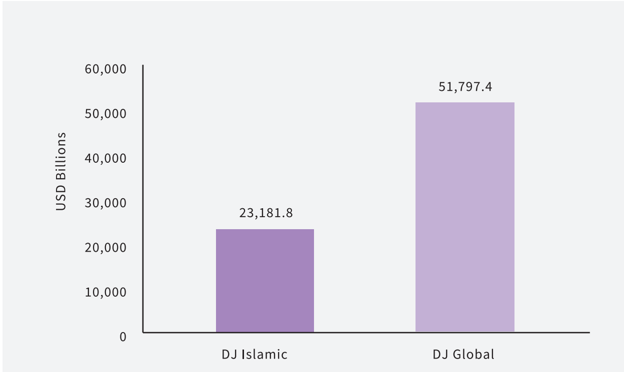


Chart 1.3.2.3 Market Capitalisation (11M15)



Source: Dow Jones, IFSB.

The comparatively better performance of DJ Islamic is partially attributable to its constituent stocks, which, following Sharī'ah principles, have abstained from investments in the conventional financial sector. DJ Islamic's major exposure is to the technology (23.1%) and health care (19.0%) sectors, whereas DJ Global's major exposure is to the financial (22.4%) and industrial (13.0%) sectors (see Chart 1.3.2.4). As per the Dow Jones Industry Indices, the five-year annualised total returns of the technology and health sectors are 11.9% and 17.9%, respectively, which compares with the lower 7.5% and 8.4% five-year annualised total returns, respectively, for the financials and industrial sectors. In terms of regional allocation, DJ Islamic also has a relatively higher proportion of investments in the Americas and a lower proportion in Asia-Pacific, in contrast to DJ Global (see Chart 1.3.2.5).

Chart 1.3.2.4
Sector Allocation (11M15)

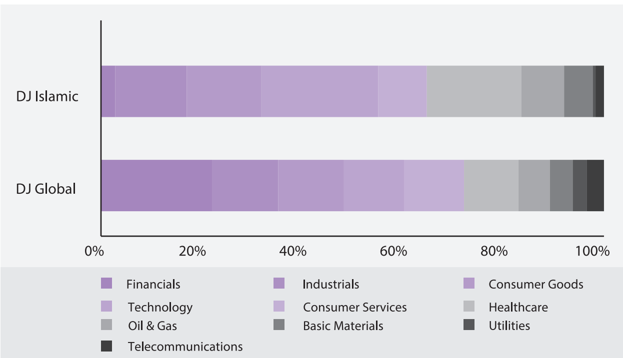
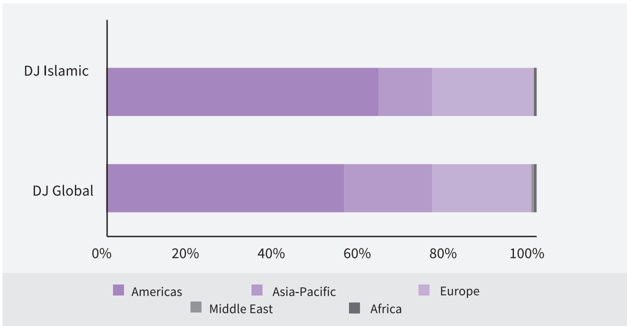


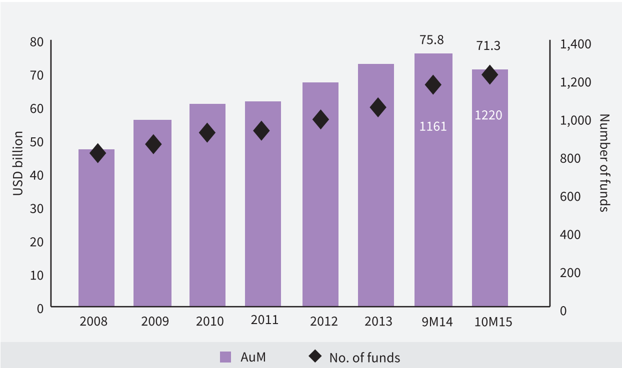
Chart 1.3.2.5
Regional Allocation (11M15)



Source: Dow Jones, IFSB.

The availability of Islamic equity listings/indices, in turn, has also enabled an Islamic funds industry to develop where fund managers are able to offer Islamic collective investment schemes to their clients. Over the years, the number of ICIS has steadily grown, from just over 800 in 2008 to more than 1200 as of 10M15. However, the general downturn in the global equity markets, combined with emerging market currency depreciations (particularly impacting domestically invested funds in Malaysia and Indonesia) in 2015, has had an impact on the net asset values of the ICIS in US Dollar terms. As of 10M15, the assets under management of the 1220 publicly available Islamic funds are valued as USD71.3 billion, a decline of nearly USD4.5 billion when compared to AuM of USD75.8 billion in 9M14, as reported in the previous stability report (see Chart 1.3.2.6). However, the number of Islamic funds publicly available in the market has in fact increased by 59 compared to the 1161 reported in FSR2015. Nonetheless, the combined effect of the increase in number of funds and decrease in aggregated USD AuM is that the average size of AuM has fallen from USD65.3 million in 9M14 to USD58.4 million in 10M15; this implies that a considerable number of funds may not reach a critical mass in volume which could potentially encourage mergers or, in the worst case, closures of Islamic funds struggling to find economies of scale.

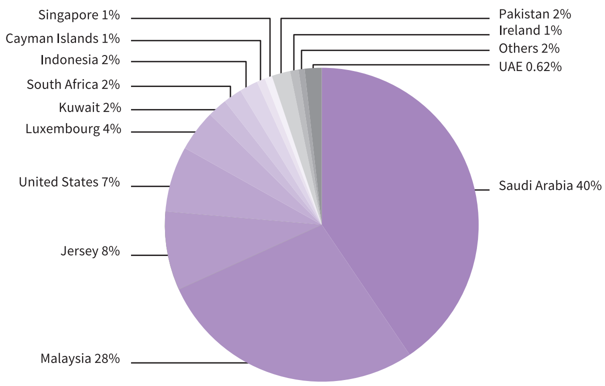
Chart 1.3.2.6
Assets under Management and Number of Islamic Funds



Source: Zawya, Bloomberg, IFSB.

The key ICIS domiciles remain consistent, with Saudi Arabia being the largest market, holding approximately 40% of the total AuM (9M14: 40%) (see Chart 1.3.2.7). Similarly, Malaysia also retains its position as the second-largest domicile for Islamic funds' assets, holding approximately 28% of the AuM (9M14: 25%). The next three domiciles in the top five are non-OIC jurisdictions – namely, Jersey (8%; 9M14: 9%), the United States (7%; 9M14: 5%) and Luxembourg (4%; 9M14: 5%). These top five jurisdictions are collectively the domiciles for 87% of the global Islamic funds by assets (9M14: 84%).

Chart 1.3.2.7
Islamic Fund Assets by Domicile (10M15)

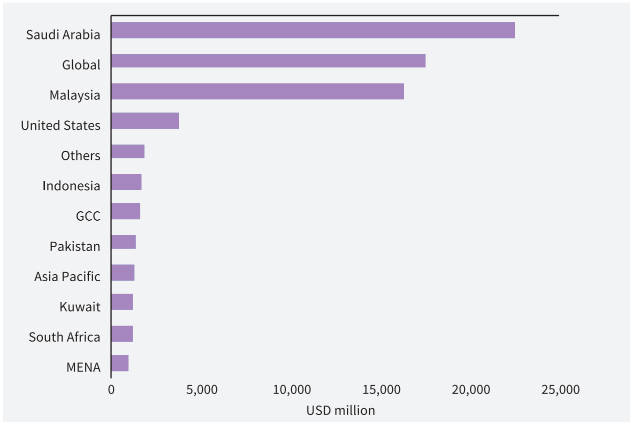


Source: Zawya, Bloomberg, IFSB.

The key ICIS domiciles remain consistent, with Saudi In terms of the geographical focus of the ICIS investments, Saudi Arabia once again is the largest focus, accounting for 31.6% of total assets (see Chart 1.3.2.8). The Saudi market benefits from a fixed-exchange rate regime; going forward, Saudi Arabian securities could attract more investments from overseas following the reversal of an earlier policy that restricted non-GCC investment in its capital markets.

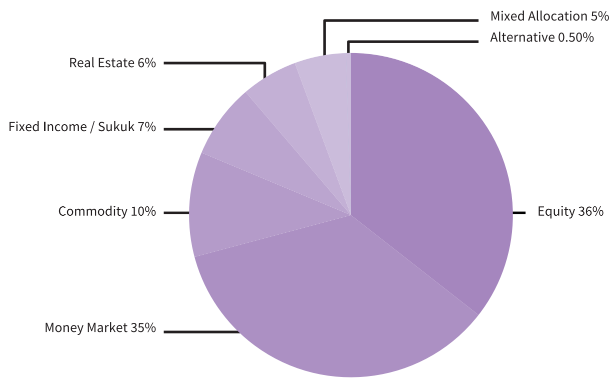
However, compared to 9M14, Malaysia has slipped to third position, being the geographical focus of 22.9% of the total Islamic funds' assets (9M14: 24%). The change is attributable to a number of factors, including heavy funds outflows from the Malaysian markets as part of the emerging markets' sell-off trend, a material depreciation in the Malaysian Ringgit in 2015, and a downturn in the performance of the Malaysian stock market. As a result, investors have possibly divested their investment focus to more global and US markets. Thus, the global[24] investment focus is now the second-most material, with a 24.6% focus, while the US market is ranked fourth, with a 5.3% focus.

Chart 1.3.2.8
Islamic Fund Assets by Geographical Focus (10M15)



Note: "Others" comprises countries/regions that have not been listed in the chart (e.g. Egypt, Jordan, United Kingdom, Europe, etc.).
Source: Zawya, Bloomberg, IFSB.

Chart 1.3.2.9
Islamic Fund Assets by Asset Class (10M15)



Source: Zawya, Bloomberg, IFSB

Finally, in terms of asset-class breakdown of the global Islamic funds' AuM, the share of equity has dropped slightly to 36% in 10M15 (9M14: 38%), while the share of the money market has increased to 35% in 10M15 (9M14: 33%) (see Chart 1.3.2.9). This change is due partly to the

[25] Global focus funds are those investing in two or more countries without a specific jurisdictional focus. They could include countries/regions that have been listed separately in Chart 1.3.2.8.

contracting equity values in 2015 and also, in the wake of possible interest rate increases, to an increasing appetite for short-term fixed-income instruments by investors as opposed to longer-term fixed-income instruments. The other significant asset classes include commodities, fixed-income/*sukūk*, mixed allocation and real estate.

Conclusion

The principles of Sharī'ah that govern the Islamic capital markets are possibly contributing to a more resilient returns performance of Sharī'ah-compliant equities. In this report, the Dow Jones indices were used as proxies to benchmark the comparison; despite a smaller asset universe with fewer components and lower market capitalisation, the Sharī'ah-compliant benchmark equity index outperformed the comparable conventional index, mainly due to its lower exposure to the conventional financial sector. Nonetheless, the Islamic funds sector remains a niche in the global Islamic financial services industry. The number of publicly available ICIS has expanded in 2015, although their AuM in US Dollar terms have declined due to a general downturn in the global equity markets and material currency depreciations in the emerging markets.

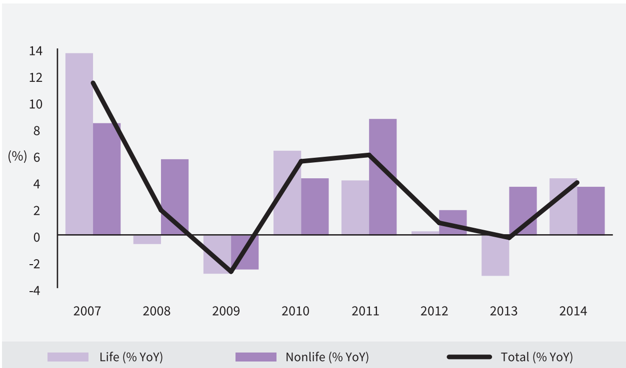
A key challenge for the Islamic fund managers remains amassing scale and market share by way of penetrating the institutional investor segment. These funds would include national pension and sovereign wealth funds. In this regard, the Malaysian pension fund, the Employee Provident Fund (EPF), has announced plans to offer Sharī'ah-compliant pension accounts to its savers starting as early as 2016. Similarly, the Malaysian sovereign wealth fund, Khazanah Nasional Berhad, has been an active player in the Islamic capital market in terms of both equity investments and *sukūk* issuances. In Dubai, UAE, the Emirate's sovereign wealth fund, the Investment Corporation of Dubai, has also participated in the Islamic capital market, by way of issuing *sukūk* for Sharī'ah-compliant investments. Apart from the Islamic finance domiciles, many institutional investors in the non-OIC jurisdictions seek socially responsible and ethical investment opportunities, which can be catered for by Islamic financial offerings, including Islamic funds. These represent key opportunities for the Islamic funds sector to gain traction and expand its coverage, liquidity and depth.

Overall, the industry's financial ecosystem, particularly the availability of a regular and steady supply of Sharī'ah-compliant financial instruments (e.g. regular *sukūk* issuances by central banks and MDBs) and other investment avenues for fund managers, is critical in determining the successful growth and expansion of the Islamic funds market. This, in turn, can contribute towards expansion of Islamic wealth management solutions (in the form of Islamic pension funds, foundations and trusts), which will further add liquidity and depth to the IFSI as a whole.

1.4 *TAKĀFUL*: DEVELOPMENT REVIEW

The global insurance market had a fair growth rate in 2014 with considerable variation across regions and countries. In that year, global real premium growth rates were realised as 2.9% in the advanced economies and 7.4% in the emerging and developing countries.[25] While both global life and non-life insurance growth rates were slower in the post-crisis era compared to the pre-crisis years, stagnation in life insurance seemed to be more pronounced in the latter period. On the other hand, life insurance gained momentum in 2014, driven mainly by growth of the industry in China and better sale performance in Europe and Japan compared to the previous year (see Chart 1.4.1).

Chart 1.4.1
Growth Rate of Premiums in Insurance Sector (Total, % YoY)



Source: Swiss Re (2015), Sigma-World Insurance Database.

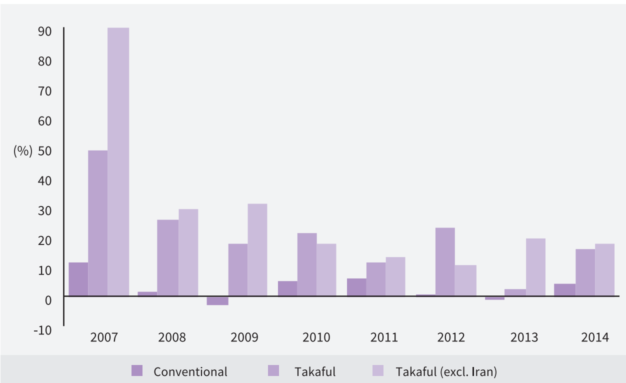
Similar to the rebound in the insurance sector globally in 2014, the global *takāful* industry also had better growth with respect to contributions in 2014 compared to 2013, when the growth rate of premiums was historically at its lowest level.[26] Indeed, the growth rate of gross premiums fell to low single digits (2.8%) in 2013 and then bounced back to 15.5%, close to the 2009–2013 growth rate average (see Chart 1.4.2). In 2013, it was the large drop in gross contributions in Iran that gave rise to poor performance in the overall *takāful* sector, but quick recovery in 2014 helped robust performance in that year. Indeed, if Iran is

[25] Swiss Re (2015), Sigma-World Insurance in 2014: Back to Life.
[26] The *takāful* data in this section are extracted from the World Islamic Insurance Directory 2015, published by *Takāful* Re and Middle East Insurance Review. In the directory, *takāful* data are available for 27 countries, while gross contribution income data are available for only 22 countries. So, the available data are assumed to represent the whole *takāful* sector and the numbers are used accordingly. Moreover, results should be used with caution, as the levels and growth rates are in terms of US Dollars and so encompass exchange-rate effects.

omitted, global *takāful* growth rates in the last two years were an improvement on the 2010–2012 period.

Overall, gross contributions growth rates were positive in both the conventional and *takāful* sectors with significant variation over the regions in 2014[27] (see Chart 1.4.3). In the GCC region, both conventional and *takāful* sectors had positive growth rates of nearly 15%, though *takāful* outgrew its conventional counterpart. On the other hand, growth of the *takāful* industry was astounding in the East Asia and Pacific (EPAC) region compared to the conventional segment. In 2014, *takāful* grew at 19.4% in this region, the highest growth rate globally, thanks to a figure of over 25% in Malaysia, while growth in the conventional segment remained at 0.7% in that year. Similar to the EPAC region, growth of *takāful* far outpaced conventional insurance in North Africa. In spite of the fact that the *takāful* industry kept pace with its conventional counterpart in Algeria, it is the ten-fold growth performance of the *takāful* sector compared to the conventional sector in Egypt (22.4% in *takāful* and 2.2% in conventional insurance) that accounted for the robust growth in *takāful* in North Africa. Conventional segments outperformed the *takāful* sector only in the South Asia (SASI) region in 2014, though to a limited extent. As regards other regions, the conventional sector contracted in the Levant, while the *takāful* sector grew by around 12.8% in 2014. This is mostly due to contraction of the conventional sector in Turkey (in both nominal and USD terms).

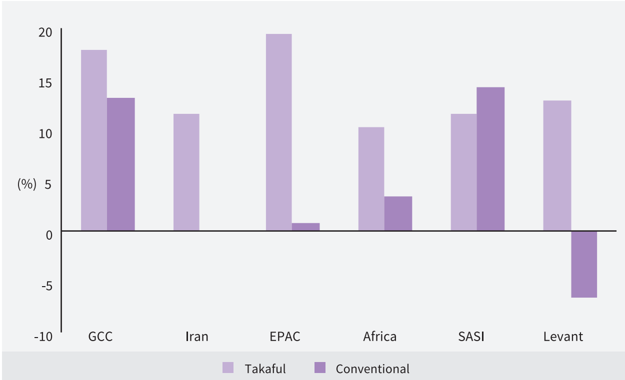
Chart 1.4.2
Growth Rate of Premiums in *Takāful* and Conventional Insurance Sectors (%YoY)



Source: Swiss Re (2015), Sigma-World Insurance Database;. World Islamic Insurance Directory 2015.

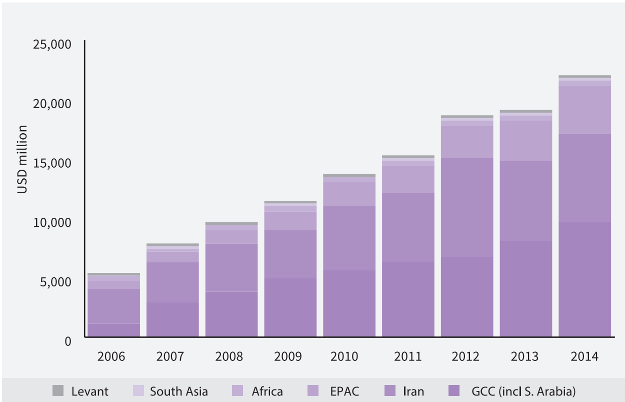
Reflected in the sector growth rates, the gross contribution size of the *takāful* industry reached USD22.1 billion in 2014, up from around only USD5 billion in 2006 (see Chart 1.4.4). The GCC region, followed by Iran and EPAC, comprise the bulk of the contributions globally. The other three regions (Africa, South Asia and Levant) had a minuscule share in the total. As both size and growth rate contribute to the growth of the industry, it would be helpful to look at the contributions to the growth as given in Chart 1.4.5. The chart underlines that the GCC region contributed the most, on average, to the growth of the global *takāful* industry.

Chart 1.4.3
Regional* Decomposition of Growth Rate of Premiums (2014, %YoY)



Source: Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015.
**GCC, EPAC, SASI and Levant (Eastern Mediterranean countries).*

Chart 1.4.4
Gross Contributions by Country Groups (2007–2014)



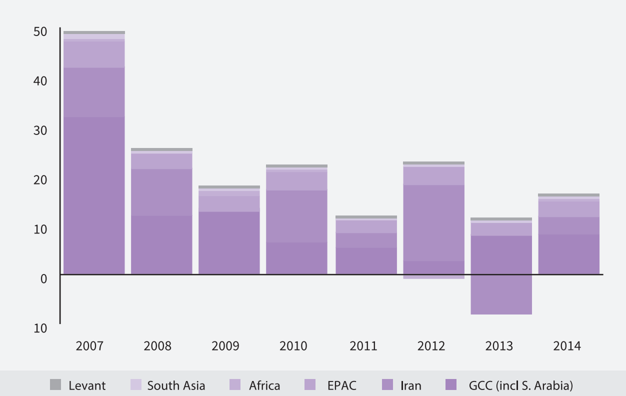
Source: Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015

Country-based decomposition of gross contributions reveals that Saudi Arabia (36.6%), Iran (33.6%) and Malaysia (13.6%) are the top three domiciles, accounting for 83.8% of the total global contributions in 2014. The other 19 countries in the sample accounted for the rest. The Saudi *takāful* market was served by around 28 cooperative insurance providers (insurance and re-insurance) with USD8.1 billion in gross contributions in 2014. Iran, with 19 *takāful* companies, accounted for USD7.5 billion in gross contributions. The Malaysian

[27] The decomposition is based on availability of data, especially for the *takāful* industry in countries. The sample is composed of the countries that have data for both *takāful* and conventional segments of the insurance industry. Given the data constraints, the regions sample is composed of the following countries that provide both conventional and *takāful* data: GCC (Kuwait, Qatar, Saudi Arabia, and UAE), EPAC (Indonesia, Malaysia, Thailand), North Africa (Algeria, Egypt), SASI (Bangladesh, Pakistan, Sri Lanka) and Levant (Jordan, Turkey).

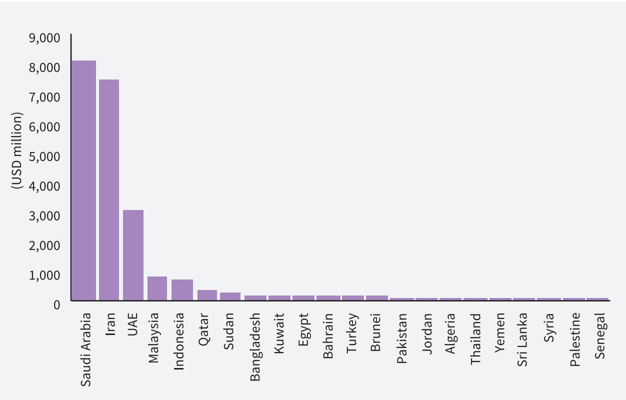
takāful market was served by 17 *takāful* operators (*takāful* and *retakāful*) with a total gross contribution of USD3 billion in the same year (see Chart 1.4.6).

Chart 1.4.5
Contributions to Total Growth of *Takāful* Industry (2007–2014)



Source: Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015.

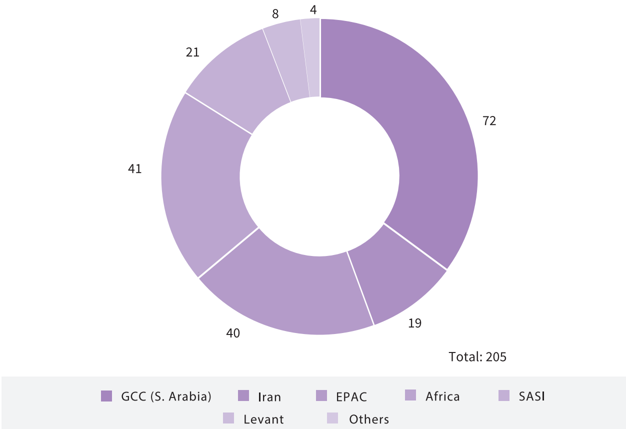
Chart 1.4.6
Gross Contributions by Country (2014)



Source: Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015.

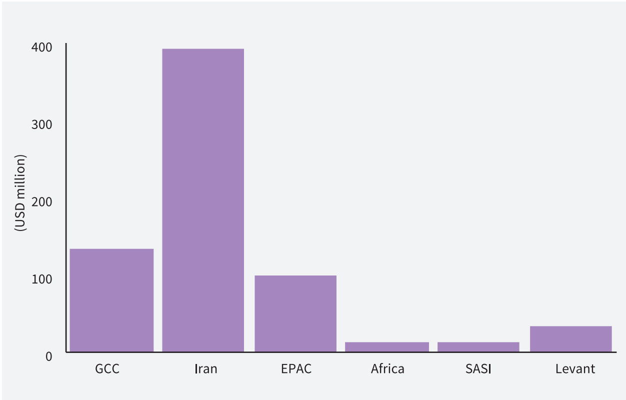
Regarding the supply side, the GCC region has the largest number of *takāful* and *retakāful* operators (72 out of 205), as a reflection of its size in gross contributions globally (see Chart 1.4.7). While size of gross contributions in Bahrain, Kuwait, Qatar and the UAE are quite small compared to Saudi Arabia, growth rates in these countries are quite robust and promising. These countries have enacted important regulatory changes over the last year, such as enhanced liquid asset requirements in Kuwait and a new solvency regime in Bahrain. These policy measures are expected to improve the health of the *takāful* industry.[28] On the other hand, these strict regulations may incur extra costs in the industry, which are already high both in the conventional and *takāful* segments, due mostly to the small scale of the operators in the region, averaging only USD134 million in gross contributions per operator (see Chart 1.4.8).

Chart 1.4.7
Number of *Takāful* Operators (2014)



Source: World Islamic Insurance Directory 2015.

Chart 1.4.8
Gross Contributions per *Takāful* Operator (2014)



Source: Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015.

There were 40 *takāful* and *retakāful* operators in the EPAC region, 16 of which reside in Malaysia. As the most important *takāful* player in the region, Malaysia's *takāful* business is likely to become more competitive due to implementation of the country's Life Insurance and Family *takāful* Framework under the Islamic Financial Services Act 2013. BNM will require *takāful* operators to separate their family and general business by 2018, and this requirement is expected to trigger extensive merger activities in the sector in the coming years. Indeed, the average gross contribution per *takāful* operator is only USD99 million, the smallest contribution among the top three regions with respect to size of the industry. The mergers may therefore help the operators converge to

[28] Standard & Poor's (2015), *Islamic Finance Outlook, 2016.*

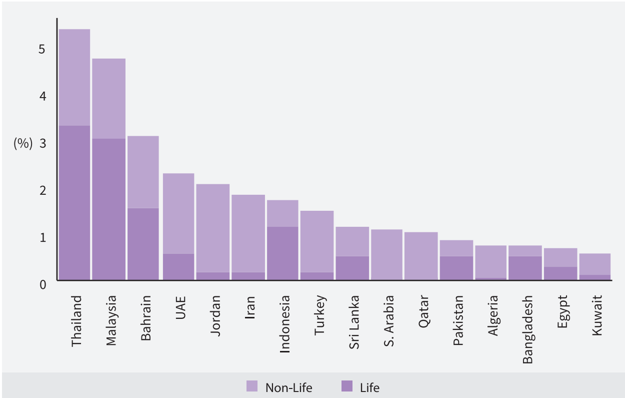
their efficient economies of scale. Moreover, separation of these two business lines is expected to allow regulators to better assess prudential risks, given the different complexities and risk profiles of the respective products. In Indonesia, a phasing out of the window operations will likely help the sector to increase its capitalisation.

While Iran lagged behind all the other regions, with the exception of Levant, with respect to the number of its *takāful* and *retakāful* operators, it had a significantly higher gross contribution per operator (USD392.5 million), three times that of the next highest region. Although Africa, South Asia and Levant had contributions above USD100 million, gross contribution per operator in these regions was quite low. This was a by-product of both the large number of operators and a low gross contribution base (market size).

There is an untapped insurance market in many of the countries in which the *takāful* sector already operates. As per Chart 1.4.9, the average insurance penetration rate in a set of countries in which the *takāful* industry operates[29] is only 1.8%. As almost all of the countries have a growing middle-class and young populations with solid growth prospects, penetration rates could conceivably increase to much higher levels. Markets such as Turkey, Saudi Arabia, Pakistan, Qatar and Egypt have penetration rates even lower than the average rate over the sample covered in the chart, which is already low in international terms.[30] The types of insurances represented by the sample vary considerably. For instance, life insurance dominates the insurance sector in Thailand, Malaysia, Indonesia, Bangladesh and Pakistan; while General insurance schemes have a higher share in other countries, especially in the GCC and Levant regions.

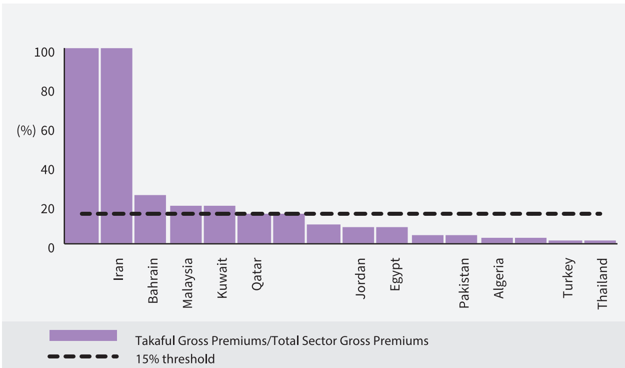
The share of the total insurance sector's gross premiums accounted for by the *takāful* sector also indicates that the *takāful* sector is untapped, especially in a number of strategically important markets. Chart 1.4.10 shows that the share of *takāful* gross premiums exceeds 15% only in Saudi Arabia, Iran, Bahrain, Malaysia, Kuwait, Qatar and Bangladesh. The ratio is below this threshold in all of the countries of the Levant and North Africa, and in most of South Asia and South-East Asia. The currently low penetration rates, combined with high population growth and a rising middle class in the countries below the threshold level, indicate there is ample opportunity for further growth of the insurance sector, including the *takāful* industry.

Chart 1.4.9
Insurance Penetration Rates in Selected Countries (% GDP, 2014)



Source: Insurance Information Institute (2015), International Insurance Fact Book; Swiss Re (2015), Sigma-World Insurance Database; IMF (2015), World Economic Outlook Database.

Chart 1.4.10
Share of *Takāful* Gross Premiums to the Total Gross Premiums by Selected Countries (2014)



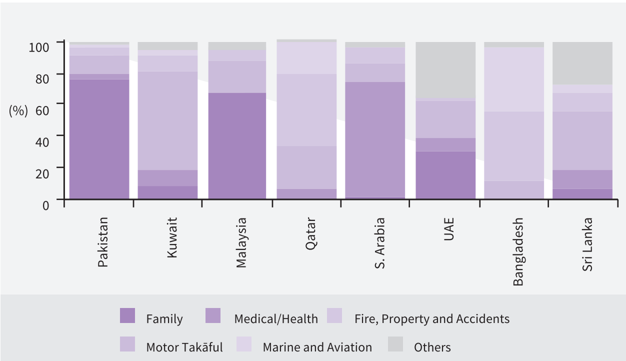
Source: Insurance Information Institute (2015), International Insurance Fact Book; Swiss Re (2015), Sigma-World Insurance Database; World Islamic Insurance Directory 2015.

Business profiles of *takāful* operators in the sample[31] differ among the countries to a great extent (see Chart 1.4.11). In Malaysia, family *takāful* is 68.1% of the total business line, which is the highest number in the sample. Young population demographics, a dynamic social security system, a high working population, and saving incentives for retirement and education due to a growing middle class, all contribute to a high share of life insurance in Malaysia, including family *takāful*. In Saudi Arabia, the composition is quite different from Malaysia, due to compulsory health coverage and the absence of a tradition of long-term saving using insurance/*takāful* products. Pakistan and the UAE comprise the second set of countries with a moderate share of family *takāful*. In

[29] These countries are covered because both the World Islamic Insurance Directory and International Insurance Fact Book (2015) provide information on their levels of gross premiums.
[30] According to the International Insurance Fact Book (2015), this ratio is as high as 17.6% in Taiwan, 15.4% in South Africa, 13.2% in Hong Kong, 12.6% in the Netherlands, 11.9% in South Korea and 7.5% in the US.
[31] As there is no globally comprehensive dataset on decomposition of the business lines for the *takāful* sector, we compiled data from financial statements of the major *takāful* operators in nine countries. The sample encompasses 23 operators in total, a small sample compared to the total number of operators worldwide. Results in the following paragraphs reflect findings from this sample and should be interpreted accordingly.

these countries, family *takāful* accounts for around 30% of the sector. On the other hand, share of family *takāful* is quite low in other countries in the sample, ranging from 8.6% in Kuwait to 0% in Bangladesh and Qatar. As birth rates are quite high and the middle class is increasing its share in the sample countries, policy initiatives towards increasing public awareness and policies encouraging long-term savings such as unit-linked instruments could result in family *takāful* increasing its share.

Chart 1.4.11
Key *Takāful* Business Lines in Sample Markets (2014)

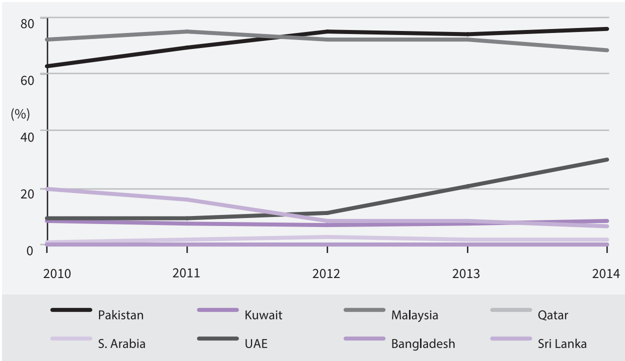


Source: World Islamic Insurance Directory 2015, IFSB Secretariat Workings.

While the current share of family *takāful* is quite high in Malaysia in international terms, trends of this share have been changing rapidly over the years for many countries in the sample. Chart 1.4.12 shows share of family *takāful* for the countries in the sample between 2009 and 2014, the latest data available. While Malaysia has been on a downward trend, family *takāful* has been gaining importance in Pakistan and the UAE, with an almost 30-fold increase for these countries in just five years. Given their trends, these two countries may catch up to Malaysia in the next five years. On the other hand, there is a sharp decline in Sri Lanka.

Motor *takāful* is the second-most important business line in the sample countries, with an average of 27.7% over the whole sample. Kuwait has the highest share of motor *takāful*, followed by Sri Lanka, Pakistan and Qatar. The third-most important business line is Fire, Property and Accidents, with the highest shares of domestic lines in Qatar and Bangladesh. Apart from these three basic business lines in the *takāful* sector, the "Others" category also has a considerable share in the UAE and Sri Lanka. This category is composed mainly of Workmen's Compensation and Energy *Takāful*.

Chart 1.4.12
Share of Family *Takāful* in Total Gross Contributions (2009–2014)



Source: World Islamic Insurance Directory 2015, IFSB Secretariat Workings.

To sum up, the *takāful* industry has a promising growth path given the size of the untapped market, favourable demographic dynamics, a rising middle class and the regulatory environment in a set of countries in which Islamic finance has been thriving.

1.5 RECENT DEVELOPMENTS IN FINANCIAL INCLUSION AND MICROFINANCE

This section provides a data-driven review of the main developments in the fields of microfinance and financial inclusion in selected markets by emphasising their nexus with Islamic financial services since previous editions of the IFSB IFSI Stability Report (IFSISR) that covered financial inclusion (FSR 2013) and microfinance issues (FSR 2014). In this respect, financial inclusion for individuals and for firms are reviewed separately,[32] thanks to the availability of two comprehensive datasets at a global level – namely, the Global Financial Inclusion Survey (Findex) and The World Bank Enterprise Surveys. On the other hand, in view of the lack of a global-level dataset on Islamic microfinance since the IFSISR 2014 in which the CGAP survey was analysed, the section on microfinance reviews recent developments at the national level by focusing on three countries (Bangladesh, Sudan and Indonesia) which provide almost 82% of the global Islamic microfinance financing.

Microfinance: Recent Developments

Around 30% of the total population in the OIC countries lives below the poverty line of USD1.25 per day. While microfinance is a potential poverty alleviation tool for this group of people, empirical findings indicate that outreach is still far below its potential. One important reason is that, as indicated by surveys and other reports,

[32] This distinction is also compatible with the World Bank approach to financial inclusion. The World Bank Global Financial Stability Report 2014 provides a detailed definition of and reasons for analysing financial inclusion for individuals and for firms separately.

a significant share of the poor Muslims reject traditional microloans.[33] Islamic microfinance has the potential of both meeting the demands of the poor, as well as the non-poor, who voluntarily abstain from conventional microfinance products due to their Sharīʿah non-compliance, while combining the Islamic social principle of caring for the less fortunate by providing assistance to the poor.[34]

As Islamic microfinance is still in its infancy and represents only around 1% of the total microfinance sector, available data is insufficient, incomplete and non-standardised. Surveys and data from national authorities are therefore used to present a picture of Islamic microfinance at the global and regional levels. Whereas a survey conducted in 2011 by the CGAP, in collaboration with the French development agency Agence Française de Développement, provided a good basis for the IFSISR 2014 to evaluate the global trends in Islamic microfinance in a comprehensive way, there has been no release of such a comprehensive report or dataset since the publication of the IFSISR 2014. On the other hand, there have been important studies carried out recently on Islamic microfinance in a number of countries, with robust and important empirical findings.

This section starts with a succinct comparative analysis of the microfinance institutions in the OIC countries and the rest of the world, in terms of developments, outreach and the impact of its conventional counterpart. The findings of some of the important recent studies are then discussed at the individual country level.

Recent studies that mostly employ impact evaluation tools such as randomised controlled trials (RCT) and non-experimental studies at the local community level aim to gauge the impact of microcredit on some important outcomes of the daily lives of the poor. Key findings of these studies are summarised in Table 1.5.1. As per the results illustrated in the table, microcredit is often used for investment and expansion of business. In spite of the fact that there is little or no evidence that provision of credit leads to sustained improvements in household income and consumption, it does "allow households greater freedom of choice in what work they do and how they spend their money".[35] There is also robust evidence that the use of microcredit increases formation of businesses. On the other hand, recent country experiences, such as in India and Bosnia-Herzegovina, suggest that uncontrolled credit expansion by the microfinance institutions (MFIs) may end up with over-borrowing syndromes with no change in incentives but the level of consumption.[36] All in all, the economic benefits of microfinance need to be carefully weighed against its inherent risks.

Table 1.5.1 Key Results of the Impact of Microcredit

Strong Evidence	Mixed or Suggestive Evidence	Little or No Evidence
Increased borrowing, given previously unmet demand for credit	Empowering for women	Large and sustained increase in income and consumption
Business formation, investment and expansion	Increase in business profits	Substantial increase in household investment in education
Increase in occupational and consumption choices	Mitigating risk and allowing households to maintain asset ownership during stress times	Harmful effects in the case of individual loans and high interest rates
Reducing impulse consumption of temptation goods in favour of more productive goods	Preventing international migration	

Source: Kathleen E. Odell (2015), Measuring the Impact of Microfinance: Looking to the Future

As indicated by the Microfinance Information Exchange (MIX) dataset, the total size of microfinance loans was around USD81.8 billion in 2014, having reached a peak in 2013 and then declined sharply. The number of active borrowers worldwide is more than 100 million. A regional decomposition of the gross loan portfolio indicates that Latin America accounts for the bulk of the loans, followed by East Asia and the Pacific region. On the other hand, the MENA and Sub-Saharan Africa (SAFR) region has a disproportionally small portfolio of loans given the potential demand (see Chart 1.5.1). As opposed to the gross loan portfolios, the number of active borrowers is highest in South Asia (SASI) followed by LATM (see Chart 1.5.2).

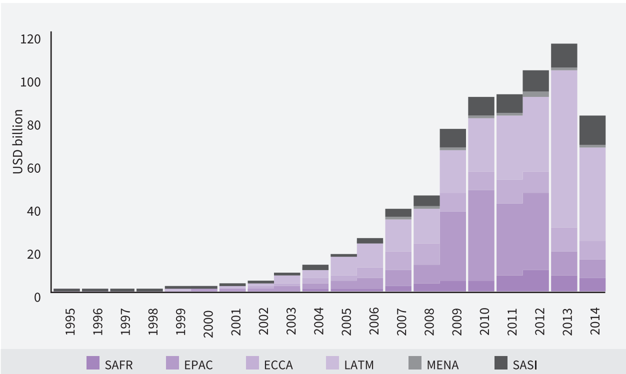
A detailed look at the OIC on the basis of the regions, as a proxy for the potential for Islamic microfinance, indicates that gross loan portfolios per borrower are lower in the

[33] Financial Services for the Poor (2015), *Islamic Microfinance: Context, Culture, Promises, and Challenges*, Bill & Melinda Gates Foundation, August.
[34] CGAP (2008), *Islamic Microfinance: An Emerging Market Niche*.
[35] Kathleen E. Odell (2015), Measuring the Impact of Microfinance: Looking to the Future, *The Grameen Foundation Publication Series, No. 3.*
[36] World Bank (2014), "Financial Inclusion: Importance, Key Facts and Drivers", *Global Financial Development Report, Washington, D.C.*

OIC countries compared to their non-OIC counterparts in all regions, except for South Asia.[37] This difference is more pronounced in the EPAC and SAFR regions. This is an interesting result and suggests the need for further analysis, as returns on assets are quite high for the OIC group, whose gross loans are comparably lower than their counterparts' (see Chart 1.5.4).

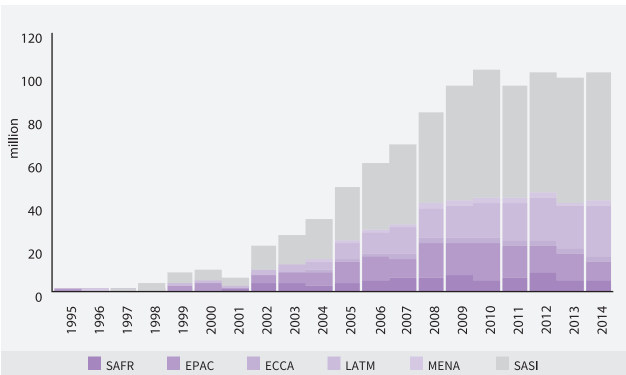
According to the CGAP 2011 survey results, there are around 225 Islamic MFI worldwide, most of which operate in the Asia-Pacific region, followed by the MENA region and South Asia. According to the survey results, around 82% of Islamic microfinance clients reside in only three countries: Bangladesh, Sudan and Indonesia. For this reason, recent developments in the Islamic microfinance sectors in these three countries are discussed in the light of the most recent data available at the local level.

Chart 1.5.1
Microfinance Gross Loan Portfolio(USD billion)



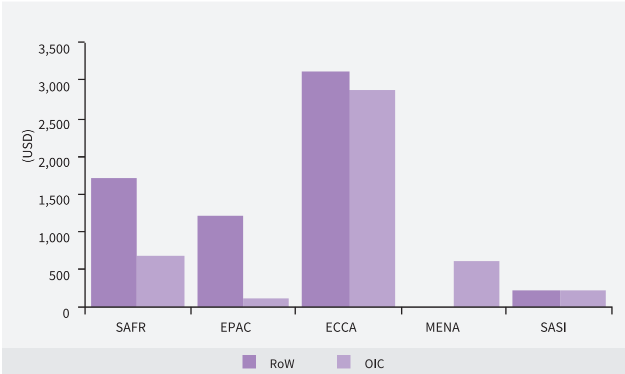
Source: MIX Database 2015, IFSB Secretariat Workings.

Chart 1.5.2
Number of Active Microfinance Borrowers



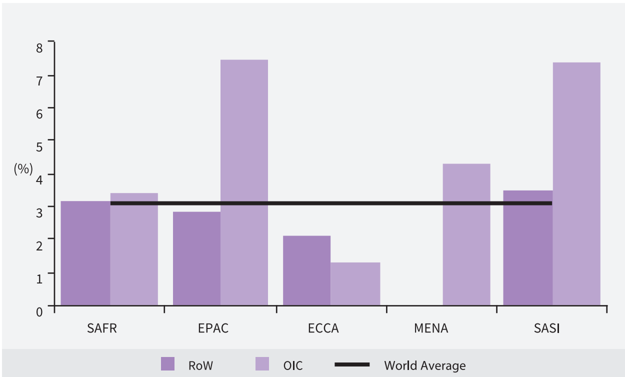
Source: MIX Database 2015, IFSB Secretariat Workings.

Chart 1.5.3
Microfinance Gross Loan Portfolio per Borrower (USD, 2014)



Source: MIX Database 2015, IFSB Secretariat Workings.

Chart 1.5.4
Return on Assets (ROA)



Source: MIX Database 2015, IFSB Secretariat Workings.

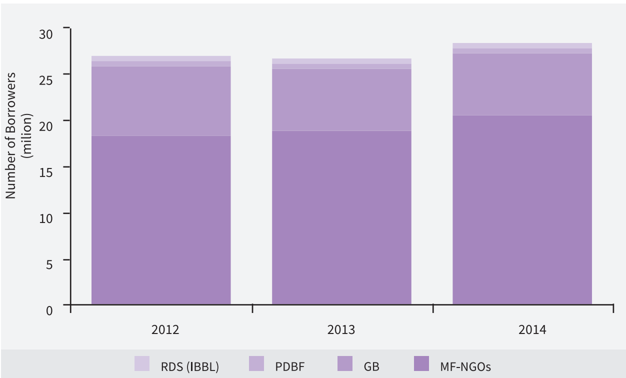
Islamic microfinance in Bangladesh is offered principally through a single institution, the Islami Bank Bangladesh Limited (IBBL), which is the largest private bank in Bangladesh. With a total clientele of more than 6 million, it operates in 294 branches as of end-2014. The IBBL introduced the Rural Development Scheme (RDS) in 1995 with the aim of generating poverty alleviation through employment- and income-generating opportunities. The RDS programme is quite similar to the Grameen Bank's group-based microcredit model, except that the IBBL mostly uses profit- and loss-sharing instruments and delivers the investment goods directly to the customer instead of providing the loan amount in the form of cash.[38] Apart from a few other microfinance institutions that offer Sharīʻah-compliant financing facilities, RDS is the only countrywide Islamic microfinancing scheme in Bangladesh.[39] For this reason, recent developments in the RDS in Bangladesh are discussed in this section.

[37] While we also calculate gross portfolio loans for the sub-regions, different population size, gross domestic product (GDP) and share of microfinance levels make the nominal figures less reliable for comparison. We therefore rely on loan portfolio per borrower in the graph.
[38] UNDP (2012), Scaling up Islamic Microfinance in Bangladesh through the Private Sector: 6 Experience of Islami Bank Bangladesh Limited (IBBL).
[39] Other than the RDS, non-government organisations (MF-NGOs), Grameen Bank (GB), and Palli Daridra Bimochon Foundation (PDBF) provide microfinance loans in Bangladesh. As of 2014, 75% of the loans are provided by the MF-NGOs, 19% by the GB and 1.1% by the PDBF.

The total number of microfinance borrowers reached 28 million in 2014, of whom only 590,000 borrowed in the form of Sharī'ah-compliant microfinance loans, which represents only 2.1% of the total (see Chart 1.5.5). On the other hand, the growth rate of the Islamic microfinance borrowers (10.1%) exceeded the growth in number of conventional borrowers (6.2%) in 2014.

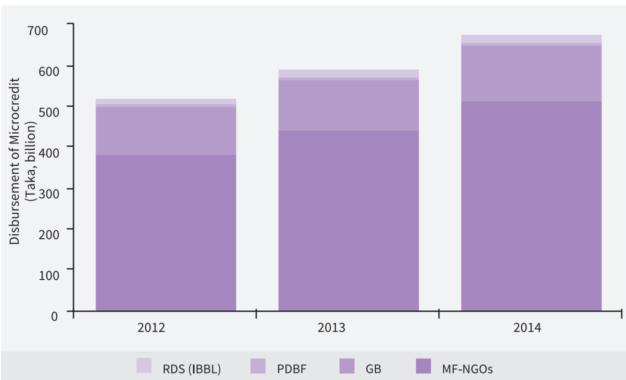
In line with the growing number of Islamic microfinance borrowers, the disbursement amount of Islamic microcredit loans was much higher (23.9%) than that of conventional loans (14.2%) in 2014, although Islamic financing's share of the total was still very low, at around 3.6%. An interesting finding from the data is that the average financing amount per borrower is much higher in Islamic microfinance despite its accounting for a minuscule proportion of the total. In 2014, the average disbursed amount in the RDS scheme was 41,000 Taka, compared to just 24,000 Taka in the rest of the sector.

Chart 1.5.5
Number of Borrowers (millions of people)



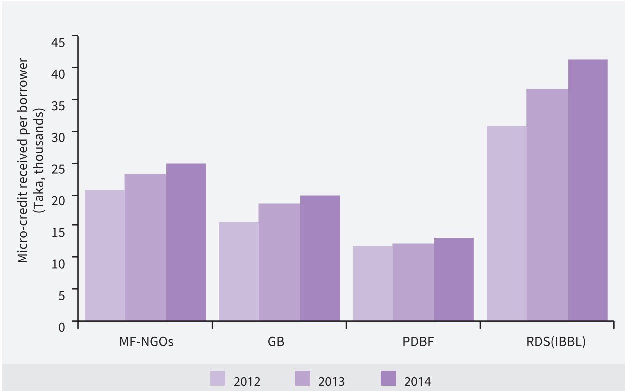
Source: Bangladesh Microfinance Statistics 2014.

Chart 1.5.6
Disbursement of Microcredit (Taka in billions)



Source: Bangladesh Microfinance Statistics 2014.

Chart 1.5.7
Micro-credit Received per Borrower (Taka in thousands)



Source: Bangladesh Microfinance Statistics 2014.

In terms of Islamic microfinance client outreach, Sudan is ranked second after Bangladesh and is the only country among those covered in this section with a totally Islamic microfinance system. It can thus help to shed light on how to implement effective Islamic microfinance practices, due to the fact that it is a natural experiment in both theory and policy. Sudan ranks fourth in terms of outstanding microfinance portfolio, following Bangladesh, Indonesia and Lebanon. The extent of outreach and portfolio size are both notable considering that the population of Sudan is quite small compared to other countries that rank high with respect to the development of Islamic microfinance.

The rapid expansion of the Islamic microfinance market is a reflection of an active central bank which has prioritised microfinance lending through a dedicated unit.[40] The sector is guided by the regulatory framework issued in 2011, which requires the Central Bank of Sudan (CBOS) to set up microfinance units in each of its branches. Since the publication of IFSISR 2014, two important policies have been introduced by the CBOS. In 2014, it regulated the sector to direct microfinance financing into productive sectors, females in rural regions, artisans, youth, and vocational training graduates. Moreover, the CBOS specified that *murābaḥah*-based financing should not exceed 70% of the total financing by the banks and that the banks should use non-traditional guarantees, such as guarantees from civil societies, and ensure consumer protection. In 2015, microfinance institutions were encouraged to increase their capital, to enhance the comprehensive insurance documents as a guarantee, and to establish the second generation of microfinance institutions, which are directed to youth, graduates, females and small enterprises.[41] With the help of the recent policy initiatives, 1.5 million new clients are expected to be reached in 2017, according to the National Microfinance Strategy.[42]

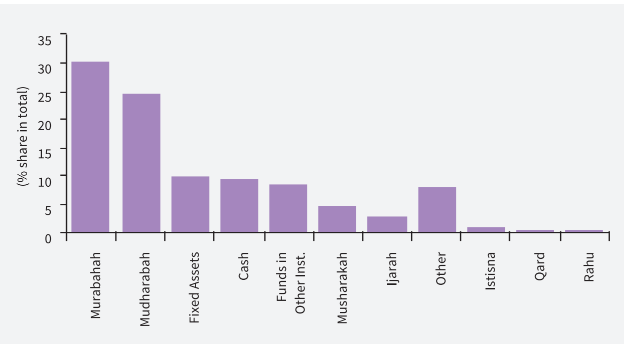
[40] IDB (2015), *Islamic Social Finance Report*.
[41] IDB (2015), *Islamic Social Finance Report*.
[42] Unfortunately, we cannot provide further data on recent developments, due to lack of consistent datasets after 2011.

In Indonesia, which is the last country covered in this section, Islamic microfinance is offered by only a small number of operators. The Baitul Maal wat Tamweel (BMT) is a cooperative model of Islamic microfinance and a combination of two institutions of Islam:[43] Baitul Maal (pooling of Islamic charity funds) and Baitut Tamweel (pooling of Sharī'ah-compliant modes of financing such as equity, savings and deposits).[44] Recently, *microtakāful* is also being integrated into this model.

The BMTs were allowed to operate as informal and unincorporated entities; however, in response to the need for supervision and regulation, Law No. 1 on Microfinance Institutions was issued in 2013. The law, which became operational in 2015, aims to narrow the gap between the demand for and availability of microfinance funds.

Due to their informal nature, recent statistics are not available for the BMTs. Thanks to the Islamic Development Bank and its 2014 Social Finance Report, some characteristics of a sample of the BMTs are available. The report provides a detailed look into the asset structure of the BMTs in Indonesia, which indicates that *murābaḥah* is the most dominant type of contract (30.4%), followed by *muḍārabah*-based investments (24.9%). The total of cash and funds in other institutions also comprises an important share in total assets (18.1%). *mushārakah*-, *ijārah*- and *istisnā*`-based assets each account for less than 5% of the total (see Chart 1.5.8).

Chart 1.5.8
Asset Structure of the BMTs



Source: IDB (2014), Islamic Social Finance Report

Financial Inclusion for Individuals: Some Reflections from the Findex Survey

In its simplest form, financial inclusion can be defined as the share of the population which directly uses financial services.[45] That is to say, if a person can acquire access to finance, he or she can elect to stay outside of the financial system voluntarily, due to distrust of the financial system or for religious reasons. In this sense, Islamic finance can play an important role in attracting those people who are voluntary excluded from the financial system due to religious concerns, as well as those who are involuntarily excluded from the system.

The Global Financial Inclusion Survey (Findex) by the World Bank aims at gauging outreach of the financial system at the country level, understanding the role both of the respondents' characteristics (age, sex, marital status, etc.) and external factors in their being financially excluded. The survey was carried out in 2011 and 2014 as part of the Gallup World Poll, which has surveyed around 1,000 people in each country since 2005 by using randomly selected, nationally representative samples over 15 years of age.[46] The Findex databases in 2011 and 2014 each covered almost 150,000 people in 140 and 143 countries, respectively. The questionnaire asked the respondents about different aspects of financial inclusion, and their responses can be grouped under four general rubrics. The first one relates to ownership, purpose and use of formal accounts. Under this rubric are frequency of using the accounts, mode of access, the purpose of the accounts, barriers to using the accounts and alternative mechanisms to the formal accounts. The second rubric looks at the saving behaviour of the respondents, such as whether they have saved, and the form and purpose of their saving. The third one looks at borrowing behaviours and use of credit, such as sources and purposes of borrowing. The last rubric focuses on use of insurance products for health care and agriculture.

As opposed to an increase in sophistication of the financial products (financial engineering), a high volume of financial flows across the countries (globalisation) and the overall trend towards financial deepening of the domestic financial markets (financialisation), the degree of financial inclusion is still not at a level that is compatible with the aforementioned trends at the global level. At the individual level, being financially included is measured by account ownership at a financial institution or through a mobile money provider. The respondents reported that low level of income, already having an account through other family members, the cost of using financial services, distance to financial centres, documentation impediments, trust in the financial system and religious considerations are the most important factors, in order of importance, in their staying out of the formal financial system. Across the population segments, it seems that the

[43] As clearly articulated in the IDB's Islamic Social Finance Report (2014) "To establish a BMT is not a complicated process. A group of people who are interested to establish a BMT in their society need to find support from their community leaders and prominent members of the society. With the approval and support of the community leaders, this group can make a founding committee (P3B) consisting of 5 people. The main job of this committee is to get 20–40 people as founder members who would like to invest in the initial share capital (simpoksus) of the BMT. With initial capital in the range of US $2,000–3,500, members may have the first general meeting to formally establish BMT and appoint the management. Out of the surveyed BMTs, about 70% were formed by groups; the remaining by individuals, cooperatives, NGOs, financial institutions, local governments and others."
[44] IDB (2014), *Islamic Social Finance Report.*
[45] World Bank (2014), "Financial Inclusion", *Global Financial Development Report*, Washington, D.C.
[46] For a detailed exposition of the database and survey methodology, see http://go.worldbank.org/IGRTPHK660

poor, women, youth and rural residents are more prone to facing difficulties in accessing finance in both of the survey years (2011 and 2014).[47] According to the Findex Survey 2014, 38% of the eligible individuals in the world still do not have a bank account in 2014, which amounts to an 11 percentage points (ppt) decrease compared to the 2011 survey data.

Apart from global statistics in the latest dataset, the data from the OIC country group[48] provides some inferences about the potential for Islamic finance to address impediments in using the formal financial system.

Despite a significant increase in ownership of bank accounts at the global level between the two waves of the Findex surveys, the OIC countries[49] seemed to lag behind the rest of the world. Indeed, as per the 2014 survey results, only 31.7% of the respondents in the OIC country group had a bank account,[50] which amounted to an improvement of 9 ppt compared to the 2011 dataset (see Chart 1.5.9). While the level was still quite low in the OIC, the improvement was almost in line with the rest of the world over this period (The improvement was around 10.5 ppt in the rest of the world.) Moreover, there is significant variation within the OIC[51] group with respect to having a bank account. While the share of respondents who have a bank account, as a proxy for the degree of financial inclusion, in the GCC and EPAC regions is above the world average, the degree of being financially included in the rest of the OIC region is quite low (see Chart 1.5.9). In the GCC and EPAC regions, the change in the average number of financially included individuals was also above the world average. In addition to these two regions, ECCA also surpassed the world average with respect to the degree of improvement in having a bank account. Despite these developments, the SAFR, MENA and SASI underperformed, both in terms of having a bank account and improvement in having a bank account, between the two survey waves.

The Findex dataset also provides information about the importance of religious reasons for not having a bank account, which is assumed as a proxy for measuring the degree of behavioural aspect in staying out of the financial system, which has the potential to be addressed through Islamic finance.[52] According to the 2014 dataset, religious reasons are responsible for 11.6% in the OIC group, compared to 4% in the rest of the world. Interestingly, these numbers amount to an increase from 8.8% and 3.2%, respectively, in the OIC and Rest of the World (RoW) groups recorded in the 2011 survey (see Chart 1.5.11).

Regional decomposition of this variable within the OIC group and its evolution between 2011 and 2014 reveals interesting results (see Chart 1.5.12).[53] Only the EPAC region is below the world average in both of the survey waves, while the level of not having a bank account due to religious reasons increased six-fold between these periods. Whereas the SAFR region was around the world average in the 2011 wave, it was above the world average in the 2014 wave.[54] The ECCA region has by far the highest level of financial inclusion in the OIC in the 2014 survey wave. Among the eight countries covered in this region in the Findex database, five do not have Islamic banking activities.[55] Indeed, the second- (Uzbekistan, 29.7%) and third- (Turkmenistan, 28%) highest levels of financially excluded respondents reside in this sub-region.[56] The GCC has the least financially excluded share of the sample after the EPAC, with this number even declining marginally between the two waves. In spite of the fact that the MENA and SASI regions still had a high share of unbanked persons due to religious motives, these two regions succeeded in scaling the numbers down significantly.

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[47] World Bank (2014), "Financial Inclusion", *Global Financial Development Report, Washington, D.C.*

[48] The Findex dataset does not reveal information about the religious affiliation of respondents. In this sense, the OIC country group is used as a proxy for Muslim populations. On the other hand, it should be kept in mind while reading the numbers that Muslim share in total population is uneven across the OIC countries.

[49] The OIC group consists of 57 countries. Due to the availability of data, we have 42 countries in our sample.

[50] Regarding the following comparable analyses, survey weights are employed in calculating the summary statistics so as to ensure that a nationally representative sample is used for each country. Unfortunately, primary sampling units (PSU) and strata variables are not readily given in the raw dataset, so formation of the survey set utilises only sample weights. On the other hand, lack of the PSU and strata variables do not lead to biases in the analysis.

[51] The regions are defined in line with the World Bank decomposition of the member countries. The decomposition is as follows: Sub-Saharan Africa (SAFR): Benin, Burkina Faso, Cameroon, Chad, Côte d'Ivoire, Gabon, Guinea, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Somalia, Sudan, Togo, Uganda. East Asia and Pacific (EPAC): Indonesia, Malaysia. Europe and Central Asia (ECCA): Albania, Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkey, Turkmenistan, Uzbekistan. Gulf Cooperation Council (GCC): Bahrain, Kuwait, Saudi Arabia, United Arab Emirates. Middle East and North Africa (MENA): Algeria, Egypt, Iraq, Jordan, Lebanon, Palestine, Tunisia, Yemen. South Asia (SASI): Afghanistan, Bangladesh, Pakistan.

[52] The question is: "Please tell me whether each of the following is a reason why you, personally, do not have an account at a bank or another type of formal financial institution." Respondents were allowed to give multiple reasons for not having an account. In the 2014 survey, 59% of adults identified lack of money as a reason, while 16% of all the respondents cited it as the only reason.

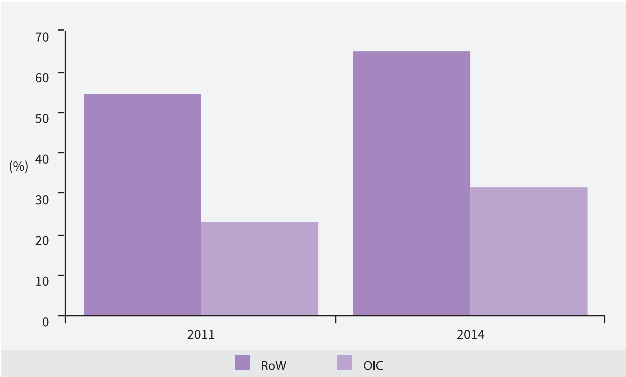
[53] The regional weighted averages of Muslim share in the OIC regions are calculated to ensure that the survey results are in line with the financial inclusion trends of Muslims. As per the calculations, the weighted averages of the Muslim share in the populations are as follows: SAFR 52.7%, EPAC 85.7%, ECCA 92.9%, GCC 92.9%, MENA 96.2% and SASI 94.1%.

[54] Half of the sample countries in the SAFR region do not have Islamic banking activities.

[55] Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan.

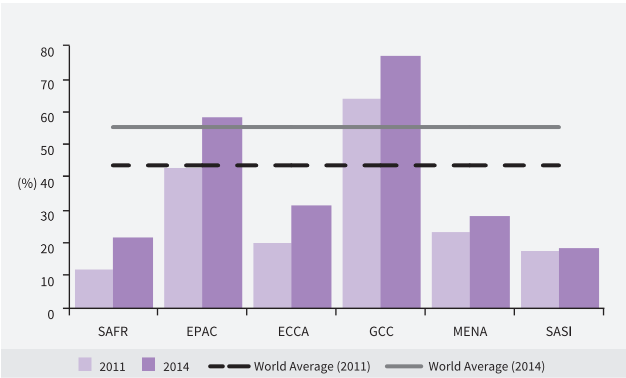
[56] The highest level in the world is in Niger (33%).

Chart 1.5.9
Having an Account at a Financial Institution (global level)



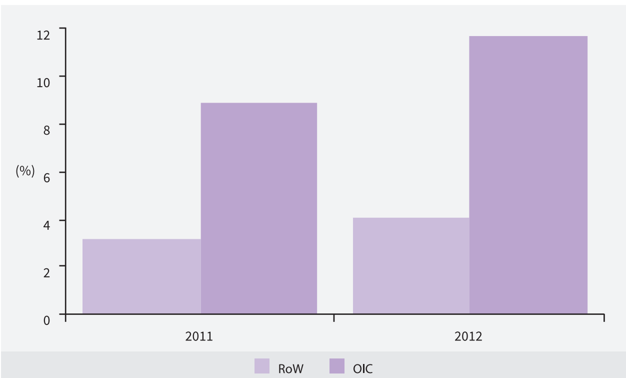
Source: The World Bank Financial Inclusion Datasets (2011, 2014).

Chart 1.5.10
Having an Account at a Financial Institution (OIC regions)



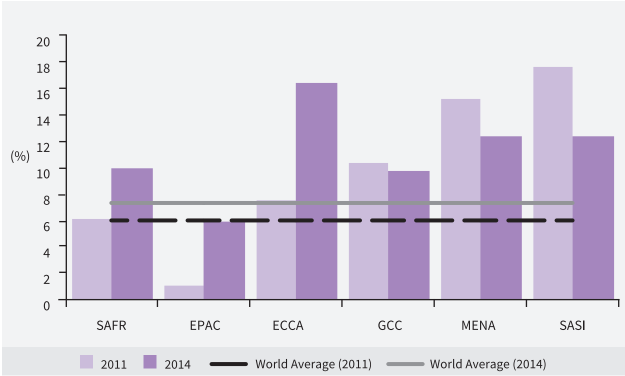
Source: The World Bank Financial Inclusion Dataset (2011, 2014).

Chart 1.5.11
Not Having an Account Due to Religious Reasons (Global level)



Source: The World Bank Financial Inclusion Dataset (2011, 2014).

Chart 1.5.12
Not Having an Account due to Religious Reasons (OIC decomposition)



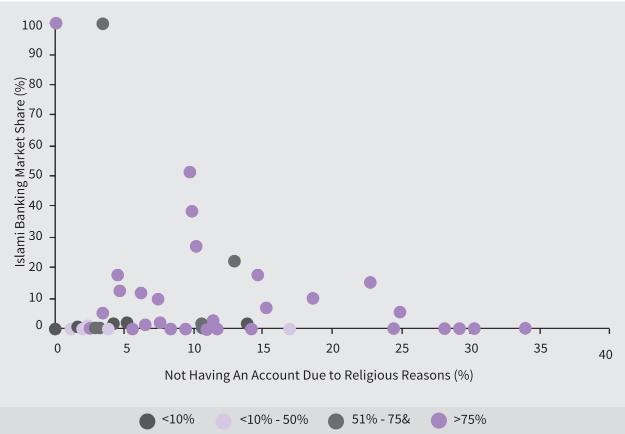
Source: The World Bank Financial Inclusion Dataset (2014).

As a continuum of being excluded from the financial system due to religious motives across the OIC group, Chart 1.5.13 attempts to identify any prospective association between the size of Islamic banking and being financially excluded due to religious reasons.[57] To clarify the results, the dataset is also further decomposed with respect to the share of Muslims in the total. This is mostly due to the fact that the advent of Islamic banking in countries in which Muslims do not constitute an important majority may have little effect on financial inclusion due to religious reasons. The results could therefore be diluted without controlling for the Muslim share.

Chart 1.5.13 encompasses 51 countries that are either OIC countries covered in the Findex dataset or non-OIC countries with a positive market share of Islamic banks in the overall banking sector. The chart shows the association between the market share of Islamic banking (in the overall banking sector) and the country-level average share of unbanked due to religious reasons, and can be conceived of as a consolidation of three sets of countries. The first group is composed of countries with no or a very small share of Islamic banking with a wide range of unbanked due to religious reasons (between 0% and 35%). There seems to be no significant association between the two variables in this group. The second group, which mostly covers the upper-income OIC countries, is clustered in the south-west (bottom-left) part of the graph, which stands for low penetration and high financial inclusion, and indicates a negative association. The third group, consisting mostly of low-income developing countries, is located usually towards the north-east part of the graph and indicates a strongly negative association between market share of the Islamic banks and financial exclusion due to religious motives.

[57] Without controlling for appropriate covariates and panel structure of the relationship, it is hard to come up with any conclusive evidence on the Islamic banking and financial inclusion nexus. Therefore, the findings from the graph indicate only the level of association at best.

Chart 1.5.13
Islamic Market Share and Financial Inclusion* with Respect to Muslim Population Share



Source: The World Bank Financial Inclusion Dataset (2014), Pew Research (2015).
**The colour of the dots indicates the Muslim population share in total population. The shares are on the basis of 2010 estimations by the PEW Research Center.*

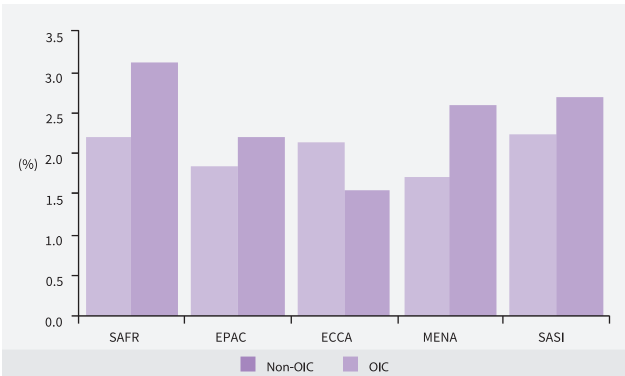
Financial Inclusion for Firms: Some Findings from the Enterprise Survey in the OIC Countries

Apart from financial inclusion for individuals, access to finance and financial inclusion of the firms are important topics for policymakers and regulators. The hindrance of firms' access to finance is much higher for the micro, small and medium (MSME) firms compared to the larger firms as confirmed by the literature and dataset both at the national and global scales. In this respect, this subsection looks briefly into the other aspect of financial inclusion, financial inclusion of MSMEs, and provides some important results extracted from the World Bank Enterprise Survey (WBES), which is the most comprehensive survey that releases information about the patterns for, obstacles to and sources of financing of firms at the global level.

The dataset encompasses around 94,000 firms from 126 countries, many of which have more than two waves of survey data available since 2002.[58] The WBES use standardised sampling methodology to produce comparable data across the countries.[59] In the survey, many aspects of the characteristics and operations of the firms are surveyed, such as gender participation, access to finance, sales, costs, labour composition, infrastructure, crime, competition, capacity utilisation, taxation, informality, business–government relations, and performance measures. In the WBES, the firms are decomposed into small (5–20 employees), medium (20–99 employees) and large firms (100+ employees). The decomposition that includes only those firms with at least five employees allows us to differentiate between financial inclusion for individuals and for firms, due to the fact that it is normally quite difficult to distinguish individuals from firms or entrepreneurs, especially in the developing countries.

In the questionnaire, an important question relates to the obstacles that firms feel they face in their current operations.[60] Chart 1.5.14 shows how SMEs in each of the OIC regions[61] compare with their peers in terms of difficulty in accessing finance. The scale ranges between 1 and 4, with the higher level indicating a more severe obstacle. As per the graph, all of the OIC regions, except the ECCA, have a higher degree of difficulty in accessing finance compared to their peer countries. The difference is quite pronounced in the SAFR and MENA regions.[62] Although it is not possible to determine an exact cause of this difference without controlling for many economic, institutional and regulatory factors, the picture clearly indicates that the SMEs in the OIC group have a higher degree of difficulty in accessing finance.

Chart 1.5.14
Having Obstacles in Accessing Finance in Current Operations for SMEs (1–4 scale*)



Source: The World Bank Enterprise Survey.
**A higher scale indicates more severe impediments experienced in accessing finance.*

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[58] In this subsection, the results reflect only the latest available survey wave for each country. As the survey is conducted every three to four years for each of the covered countries in different years, neither the time frequency nor the latest available date of the surveys is uniform across the countries.

[59] The methodology and other technical details of the survey are not delineated here due to space considerations. A further explanation of the sampling methodology and related documents can be found on the World Bank Enterprise Survey website: www.enterprisesurveys.org/.

[60] "Is access to financing, which includes availability and cost [interest rates, fees and collateral requirements], No Obstacle (0), a Minor Obstacle (1), a Major Obstacle (2), or a Very Severe Obstacle (4) to the current operations of this establishment?"

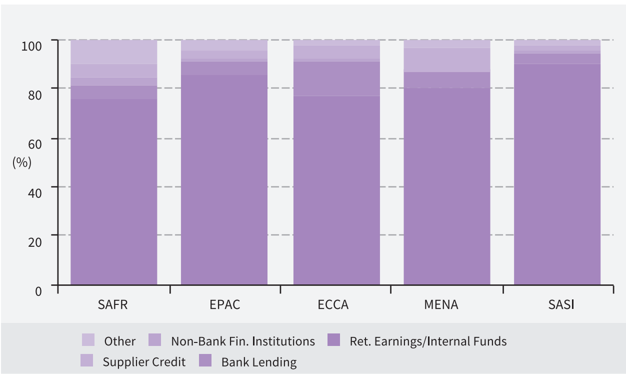
[61] Similar to the Findex decomposition, we follow the World Bank definitions to identify the OIC regions, with the further division of the MENA into the Middle East (MEAS) and North Africa (NAFR) regions. In the WBES, there is no GCC country surveyed, so we do not cover this region in the graphs. The decomposition is as follows: Sub-Saharan Africa (SAFR): Benin, Burkina Faso, Cameroon, Chad, Côte d'Ivoire, Gabon, Gambia, Guinea, Guinea Bissau, Mali, Mauritania, Mozambique, Niger, Nigeria, Senegal, Sierra Leone, Sudan, Togo, Uganda. East Asia and Pacific (EPAC): Indonesia. Europe and Central Asia (ECCA): Albania, Azerbaijan, Bosnia and Herzegovina, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkey, Uzbekistan. North Africa (NAFR): Djibouti, Egypt, Morocco, Tunisia. Middle East (MEAS): Iraq, Jordan, Lebanon, Yemen. South Asia (SASI): Afghanistan, Bangladesh, Pakistan.

[62] There is possibly a sample selection bias issue in the MENA region due to the fact that non-OIC MENA countries are Israel and Palestine, which may not be comparable to the OIC MENA group in terms of economic structures and level of development. On the other hand, even considering the OIC MENA group per se, the level is much higher than the non-OIC and OIC averages.

Sources of financing for the SMEs give some important clues in understanding important aspects of the financial inclusion problems. The WBES database allows us to look into the financing choices of the firms in two ways – namely, working capital purchases and fixed asset accumulation. In the dataset, the surveyed firm is asked what proportions of their working capital and fixed asset purchases are financed by given sorts of instruments, which sum to 100%. Working capital is defined as financing of short-term production activities and is composed of internal funds/retained earnings, bank loans, non-bank financial institutions, supplier credit and other means of financing. Fixed asset purchases include machinery/equipment, land, buildings and building improvements, and other long-term investments, and are financed by internal funds/retained earnings, new equity shares, bank loans, non-bank financial institutions, supplier credit and other means of financing.

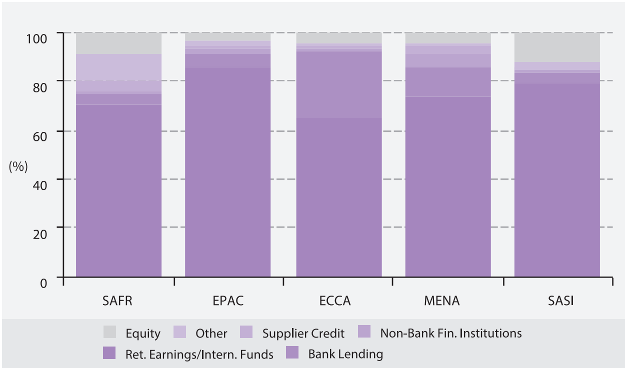
Charts 1.5.15 and 1.5.16 illustrate SMEs' sources of financing for working capital and fixed asset purchases in the OIC region, respectively. For the working capital needs, dependence on internal funds is very high all over the sub-regions, followed by bank loans and supplier credit. There is a similar pattern of financing for the fixed asset purchases of the SMEs. A very high dependence on internal funds and considerable share of supplier credit in some of the sub-regions implies that the SMEs may have problems in accessing bank loans.

Chart 1.5.15
Sources of Financing for Working Capital for SMEs



Source: The World Bank Enterprise Survey.

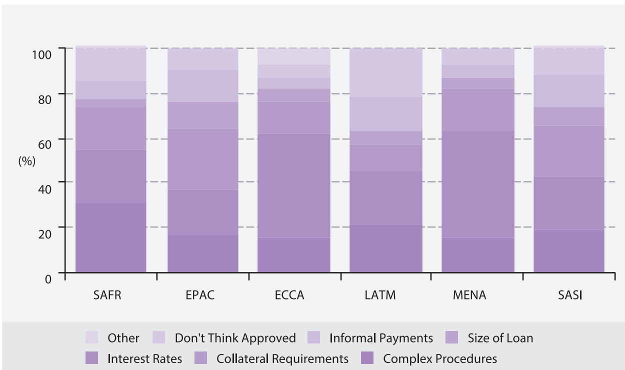
Chart 1.5.16
Sources of Financing for Fixed Asset Purchases for SMEs



Source: The World Bank Enterprise Survey.

Exclusion of the SMEs mostly stems from the lack of sufficient access to bank loans, due largely to agency problems, higher risk of default, higher collateral requirements and lack of credit history.[63] Another important fact about firm financing is that even if the banks can offer bank loans to these firms, two of the most important pillars of the loan usage – interest rates and collateral – become an obstacle in obtaining loans. As per the WBES data, high interest rates and collateral requirements are the two main impediments in SMEs not applying for bank loans, followed by complex procedures (see Chart 1.5.17).

Chart 1.5.17
Sources of Financing for Fixed Asset Purchases for SMEs



Source: The World Bank Enterprise Survey.

[63] There is a sizeable amount of informative literature on impediments to MSMEs' access to bank loans, including T. Beck, A. Demirguc-Kunt, L. Laeven and V. Maksimovic (2006), "The Determinants of Financing Obstacles", Journal of International Money and Finance, Vol. 25, pp. 932–52; and A.N. Berger and G.F. Udell (1995), "Small Firms, Commercial Lines of Credit, and Collateral", Journal of Business, Vol. 68, pp. 351–82.

1.6 OVERALL SUMMARY

Economic and financial prospects in 2015 were quite challenging at the global level, and the general slowdown in the world economy and downside risks also have repercussions for the Islamic financial services industry. That said, the global IFSI has been able to withstand these adverse effects and sustain its overall worth by both entering into new markets and increasing its share in those markets where it has already been operating. In this chapter, the growth and development of the three key sectors of the global IFSI (Islamic banking, *takāful* and Islamic capital markets), as well as the financial inclusion and microfinance aspects of Islamic finance as a fourth sector, are analysed in detail.

Islamic Banking

While total Islamic banking assets continued to grow at double-digit rates in both 2013 and 2014, there is a pronounced slowdown in this growth rate compared to the previous periods. Indeed, annual growth of the total Islamic banking assets across the sample 59 banks in 11 markets hovered around 10% in the 2013–2014 period, compared to a CAGR of 17.1% between 2008 and 2011. The slowdown in asset growth is attributable to a number of factors, including the exchange rate depreciation in emerging markets, slowdown in global economic growth performance and outlook, prolonged low energy prices in world markets, and generally weaker investor and consumer confidence in the global economy. On the other hand, given the figures for the first half of 2015, asset growth is expected once again to sustain its double-digit rate.

Regarding the deposit and financing growth of the Islamic banking industry, the double-digit growth trend continued in 2014, though there was a slowdown compared to the previous periods. As per the data from the Islamic banking sample used in this report, the annual growth rate of deposits fell to 12.5% in 2014 from an average rate of 16.1% between 2008 and 2014. Similarly, the annual growth rate of financing fell to 13% in 2014 from an average of 14.9% in the 2008–2014 period. The main reasons for this trend are revival of financing by Islamic banks during the post-financial crisis years and new Islamic banks expanding their financing portfolios following earlier periods where relatively greater focus was on deposits mobilisation.

Spatial decomposition of the Islamic banking data indicate that growth rates were robust and at double-digit rates for most countries, especially in Malaysia, the UAE, Bangladesh and Pakistan, in 2014. In Malaysia, the growth and expansion of Islamic finance is a reflection of government initiatives, due to the fact that the government has set a target of a 40% share of Islamic banking financing in the country's banking sector by 2020. Growing awareness of Sharī'ah-compliant propositions, and greater acceptance by the general public, are key factors driving Islamic banking growth in the UAE and Bangladesh. The nearly 30% financing growth in Pakistan is spurred by a recent drive where conventional banks are actively pursuing Islamic banking opportunities by way of establishing Islamic subsidiaries and Islamic banking windows, as well as pursuing full conversion of existing operations into Islamic ones.

In general, the challenging developments that paved the way for a slowdown in the growth rate of Islamic banking since 2013 are likely to last, and even to intensify, in 2015 and 2016. Indeed, recent reports by international organisations such as the International Monetary Fund (IMF), the United Nations, the WB and the BIS, have warned that the forthcoming years are likely to be more challenging in terms of the liquidity and revenues of the banking sector (Islamic and conventional), especially in commodity-exporting economies and other emerging markets. These macroeconomic challenges are also likely to somewhat slow deposit growth due to relatively weaker liquidity conditions, while asset quality is also at risk of deterioration in line with the economic slowdown. The latter increases the risk of credit losses and non-performing financing for both conventional and Islamic banks.

Islamic Capital Markets

Islamic capital markets performed well in 2014, with some volatility and setbacks in returns and asset values in line with the general trends observed in the global capital markets as a reflection of the slowdown in global economic growth, monetary policies in the advanced economies and shifting risks to the emerging markets. On the other hand, the ICM continued to expand its investor and issuer base in 2014, such as debut issuances by the Sultanate of Oman and Cote D'Ivoire in the sovereign sector, and a return of issuance by the WB's International Finance Corporation. Moreover, the share of medium- to longer-term *sukūk* (bearing maturities of three–five years and then longer than five years) has increased, although this shift is due mainly to a decline in short-term tenure *sukūk* issuances.

In 2015, given the latest data available, the *sukūk* sector has experienced a decline in both issuances activity and outstanding volume. Withdrawal of Bank Negara Malaysia as an issuer of short-term liquidity management *sukūk* in the Malaysian market was the main reason for this development, along with the depreciation of many emerging market currencies vis-à-vis the US Dollar, lower economic growth forecasts, expected rate increases by the US, and weaker investor and consumer sentiment. On the other hand, there is an expanding number of business groups utilising *sukūk* to raise funds. In addition, financial services providers have increased their issuances of revised regulatory-compliant capital adequacy *sukūk* to meet new international standards for banking-sector capitalisation. Among the challenges in the *sukūk* market, the most pronounced are differing Sharī'ah opinions on *sukūk* tradability, use of credit enhancements, and the general propensity of investors to hold *sukūk* instruments until maturity. Regarding the *sukūk* market infrastructure and its ancillary services, there has been some progress, such as rating of the *sukūk* by both international ratings agencies and domestic agencies.

Among the various types of *sukūk*, the sovereign type is expected to gain momentum in the near future as a reflection of increased budget deficit projections in several jurisdictions, including the oil exporters. Recently, the new trends of "social" and "green" *sukūk* have potential to give it a new direction towards more ethical finance.

Takāful

As a subset of the insurance sector, the *takāful* sector is closely interconnected with developments in the insurance sector overall. The global insurance market had a fair growth rate, with global real premium growth rates of 2.9% in the advanced economies and 7.4% in the emerging and developing countries in 2014, an improvement over the 2012 and 2013 rates. Similarly, the growth rate of gross contributions in the *takāful* sector showed a rebound in 2014 compared to 2013, when the growth rate of premiums was historically at its lowest level.

As a reflection of the robust growth rate, the gross contributions of the *takāful* sector reached USD22.1 billion in 2014, up from only around USD5 billion in 2006. The biggest share of the *takāful* pie belongs to the GCC countries, followed by Iran and the EPAC, which together comprise the bulk of the contributions globally. The other three regions (Africa, South Asia and Levant) had a very small share in total. As *takāful*'s share of the insurance sector is only 1%, there is a long way to go for the *takāful* sector. Indeed, the low penetration rates in a set of countries in which the *takāful* industry operates, which is only 1.8%, indicate an untapped market for the *takāful* sector. Due to the fact that many of the target markets of the *takāful* sector, such as Turkey, Saudi Arabia, Pakistan, Qatar and Egypt, have a growing middle-class and young populations with solid growth prospects, there is room for much higher penetration rates via *takāful*.

Microfinance and Financial Inclusion

The availability of recent worldwide survey datasets provides invaluable information about recent global trends in microfinance and financial inclusion. Indeed, this report gives a data-driven picture of the recent trends in these two sectors.

Islamic microfinance has significant potential, given the fact that many poor Muslims will reject traditional microloans. In this regard, Islamic microfinance has the potential both to meet the demand for loans by poor people who don't use conventional microfinance products due to their Sharī'ah non-compliance, and to adhere to the Islamic social principle of caring for the less fortunate by providing assistance to the poor. According to the available global data on microfinance, the total size of microfinance loans reached USD81.8 billion in 2014, with more than 100 million active borrowers. On the other hand, there seems to be underutilisation of microfinance in the OIC countries, with gross loan portfolios per borrower at lower rates in those countries compared to their non-OIC counterparts in all regions, except for South Asia (SASI). While there is no direct data on Islamic microfinance, country studies for Bangladesh, Sudan and Indonesia indicate that the growth rate of Islamic microfinance is much higher than that of its conventional counterpart.

Regarding financial inclusion for individuals, the WB's Findex dataset indicates that ownership of bank accounts has increased significantly at the global level between the two waves of the surveys (2011 and 2014). On the other hand, the OIC countries seem to lag far behind the rest of the world in this respect. It seems that religious reasons have an effect on this development in the OIC group. Indeed, religious reasons are responsible for 11.6% in the OIC group not having an account in a bank, while that number is just 4% in the rest of the world. Within the OIC, Europe and Central Asia, South Asia, and the Middle East and North Africa has the highest levels of being unbanked due to religious reasons.

As per the World Bank Enterprise Survey, the SMEs in all of the OIC regions, except for Europe and Central Asia, have a higher degree of difficulty in accessing finance compared to their peer countries. The difference is quite pronounced in the Sub-Saharan Africa and the Middle East and North Africa regions. SMEs' difficulties in accessing finance have resulted in a very high dependence on internal funds and a considerable share of supplier and lower use of bank credit. The survey also reveals that even if the banks can offer bank loans for SMEs, high interest rates and collateral regimes deter the SMEs from applying for a loan.

2.0 ISLAMIC FINANCE AND THE CHANGING GLOBAL FINANCIAL ARCHITECTURE

2.1 GLOBAL DEVELOPMENTS AND THE IMPACT OF IFSI

Together with the international standard-setting bodies – the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors – the Financial Stability Board has continued to publish policy papers and recommendations for the financial sectors to promote the stability of the financial services industry. The following sections highlight selected initiatives undertaken in the global financial industry since the publication of the IFSB IFSI Stability Report 2014, as well as the impact these may have on the IFSI.

2.1.1 Financial Stability Board

The FSB issued several policy documents, progress reports and consultative documents in the last year as part of its mandate to monitor and assess the vulnerabilities affecting the global financial system and their implications for regulatory policy and the corresponding development of strong regulatory, supervisory and other financial-sector policies.

(a) Group of 20/OECD Principles of Corporate Governance

The Organisation for Economic Co-operation and Development's (OECD) Principles of Corporate Governance, which is one of the FSB's 12 key standards for sound financial systems, underwent a recent review process which was concluded in 2015. The new Group of Twenty (G-20)/OECD Principles introduce some new issues and provide greater emphasis or clarity to others with respect to recent developments and corporate governance challenges. The new principles stress the importance of operational independence and accountability of regulatory, supervisory and enforcement authorities, and recommend that any conflicting objectives be avoided. In addition, the revised principles have inserted "fairness" alongside transparency and efficiency as an objective of market regulation.

One of the key changes is the addition of a new chapter, "Institutional investors, stock markets, and other intermediaries", which highlights the need for sound incentives throughout the investment chain, with a particular focus on institutional investors acting in a fiduciary capacity. It also addresses the need to disclose and minimise conflicts of interest that may compromise the integrity of intermediaries such as proxy advisers, analysts, brokers, rating agencies, and others that provide analysis and advice relevant to the investor.

Another addition is extensive and stricter rules on related-party transactions. While the earlier focus was mainly on transparency, the current recommendations require related-party transactions to be defined precisely but broadly, and exclude immaterial transactions and recurring ones that are transacted at verifiable market terms to ease the administrative burden. The new principles also require the approval of related-party transactions by independent board members or shareholders.

In relation to the board's role in risk oversight, the earlier principles focused mainly on the board's role in overseeing accounting and financial reporting systems and internal controls, while the revised version recommends more expansive risk oversight responsibilities, including ensuring that senior management oversight is in place and compliance programs are effective.

In terms of its impact on corporate governance standards for the IFSI, the revised G-20/OECD Principles of Corporate Governance do not produce a fundamental shift in governance practices, but enhance the benchmarks in a number of areas relevant to both developed and emerging markets and reflect some of the changes in the global corporate governance landscape.

(b) New measures to promote resolvability, including effective cross-border resolution

As part of FSB's policy agenda to end "too-big-to-fail" and to promote the resolvability of all financial institutions with potential for systemic failure through full implementation of the Key Attributes of Effective Resolution Regimes for Financial Institutions, the FSB issued two finalised guidance papers and three consultative documents in November 2015.

The first of the finalised papers, Principles for Cross-border Effectiveness of Resolution Actions, set out statutory and contractual mechanisms that jurisdictions may consider including in their legal frameworks to give cross-border effect to resolution actions in accordance with the Key Attributes. The need to give cross-border effect to resolution actions may arise with respect to an institution undergoing resolution in its home jurisdiction that operates a branch or controls a subsidiary in a foreign jurisdiction; or an institution that holds assets, liabilities or contracts in, or subject to the law of, another jurisdiction in which the firm is not established. The Principles provide guidance on statutory approaches, as well as contractual recognition approaches that can help support the cross-border enforceability of a resolution action.

The second paper, Guidance on Cooperation and Information Sharing with Host Authorities of Jurisdictions where a G-SIFI has a Systemic Presence that are Not Represented on its Crisis Management Group (CMG), addresses the issue that a major institution may be systemically important in a particular jurisdiction, but that jurisdiction may itself be too small to justify representation on the firm's CMG. The jurisdiction does, however, have an important interest in the outcome of any crisis affecting the firm.

The first consultative document, Temporary Funding Needed to Support the Orderly Resolution of a Global Systemically Important Bank (G-SIB), addresses the risk of insufficient liquidity for banks to maintain critical operations during a resolution. The proposed Guiding Principles are aimed at ensuring that temporary funding is available to enable the effective resolution of G-SIBs without public-sector bail-out, in a way that reduces moral hazard, with an emphasis on liquidity provision by the private sector.

The second consultative document, Arrangements to Support Operational Continuity in Resolution, proposes guidance on arrangements to ensure continuity of critical shared services, such as information technology infrastructure and software-related services, which are necessary to maintain the continued provision or to facilitate the orderly winding down of a firm's critical functions in resolution.

The third consultative document, Effective Resolution Strategies and Plans for Systemically Important Insurers, seeks to assist authorities in developing effective resolution strategies and plans for systemic insurers and to facilitate CMGs of global systemically important insurers (G-SIIs) in their resolution planning.

With respect to the IFSI, recovery and resolution is an area where there is still a lack of experience, but it is an important area for development. The IFSB 2010 Task Force Report identified eight important building blocks to further strengthen the foundations of the Islamic financial system, including a focus on "effective crisis management and resolution framework" as the fourth building block. The report identified several issues, such as legal challenges related to insolvency issues arising from Sharīʼah-compliant financial transactions, for example, in terms of the priority of claims of depositors and shareholders during liquidation of an institution offering Islamic financial services. The IIFS would be exposed to a number of risks in jurisdictions that have established insolvency rules that are not tailored to deal with insolvency issues in Islamic finance transactions.

The issue of insolvency in Islamic finance raises difficult questions, including those related to Sharīʼah. The discussion of resolution and recovery requires an understanding of the rights of each party in insolvency, which would provide an indication of other outcomes of resolution and recovery. While the FSB approach to bail-in within resolution is based on the principle that creditors required to bail-in should be no worse off than in insolvency, the treatment of IIFS in insolvency is not well-understood, and there are material Sharīʼah issues to be considered.

Additionally, while there is continuing work on cross-border recognition of resolution regimes, this is a little-studied area for IIFS. There are significant issues for consideration, which include, for example, the treatment of investment account holders (IAHs) or the Policyholders' Risk Fund of a *takāful* undertaking. The latter can be evaluated in light of the proposed recommendations in the FSB consultative document on Effective Resolution Strategies and Plans for Systemically Important

Given the above considerations, the IFSB's proposed work plan for the coming years includes a focus on resolution and recovery, which will begin with a research paper reviewing the FSB's key attributes of effective resolution regimes for financial institutions from the point of view of its applicability to Islamic finance on a cross-sectoral basis. The cross-sectoral aspects to be studied will include banking as well as other areas such as *sukūk*. The IFSB also plans to conduct a survey across member jurisdictions that is expected to provide more useful information on this subject. A number of areas related to resolution powers, including the role of the resolution authority, and of the Sharīʼah boards and other organs of governance, have scope for further expansion. This research would contribute to a good review of the literature in the mentioned areas, which will provide groundwork for the IFSB Working Paper. Thus, the specificities of IIFS that may not have been addressed in the FSB guidance paper are likely to be identified and addressed within future work undertaken by the IFSB in this area.

(c) Implementation and effects of the G-20 financial regulatory reforms

In the first annual report to the G-20 on the implementation and effects of the G-20 financial regulatory reforms, the FSB highlighted the progress made by FSB member jurisdictions in implementing the financial reforms agreed in the wake of the GFC, the effects of those reforms and the areas that need closer monitoring.

The report notes steady but uneven progress in implementation across the breadth of reforms, with the implementation of Basel III reforms on bank capital and liquidity standards ahead of schedule, but substantial work remaining in terms of implementing effective resolution regimes.

The report concludes that the most concrete effect of the reforms has been to make the global banking sector more resilient. Further, it notes that this improved resilience has been achieved while maintaining the overall provision of credit to the real economy. The report identifies three areas that warrant closer ongoing attention, including: (i) spillovers on some emerging market and developing economies from the implementation of reforms in home jurisdictions of global financial institutions; (ii) the maintenance of an open and integrated global financial system; and (iii) the causes and financial stability consequences of recent shifts in liquidity in fixed-income markets.

In addition to providing an indication of the overall reforms occurring across the global financial system, the aforesaid reforms reflect the status of developments occurring within some IFSB member countries that are also G-20 countries, such as Indonesia, Saudi Arabia and Turkey.

The FSB conducted a peer review of Saudi Arabia's implementation of regulatory reforms and published a report in November 2015. The review concluded that substantial progress has been made in the areas that were examined – namely, macroprudential policy, bank resolution and deposit insurance. The review focused on the steps being taken by authorities to implement reforms in the aforementioned areas, as well as with respect to the relevant recommendations that were made in the Financial Sector Assessment Programme (FSAP) report in 2011.

Among the key developments noted by the peer review, the Saudi Arabian Monetary Agency (SAMA) has developed and begun operationalising a macroprudential policy framework, in addition to the establishment of a high-level internal Financial Stability Committee and the issuance of its first Financial Stability Report. Other significant developments include a draft resolution law proposed by SAMA that contains elements of the FSB's Key Attributes of Effective Resolution Regimes, as well as the planned introduction of an explicit deposit insurance system as of 1 January 2016, as per the recommendation of the February 2012 FSB peer review, to replace the previous implicit one. Once it is fully implemented, the scheme is expected to further enhance the financial safety net. SAMA has also adopted a number of international practices codified in the International Association of Deposit Insurers (IADI) Core Principles, such as explicit public policy objectives and mandate of the Depositor Protection Fund (DPF), compulsory membership and legal protection for the DPF.

Noting the considerable progress that has been made, the peer review also identified areas for further development in all three facets. This includes, on the macroprudential side, the need for further strengthening of institutional arrangements, enhancement of analytical capacity for financial stability and communication of macroprudential policy measures to the public. The report also observed that the proposed establishment of a National Financial Stability Committee would serve to further strengthen the coordination between SAMA and the Ministry of Finance and the Capital Markets Authority on systemic risk analysis and adoption of measures to promote financial stability. On the bank resolution facet, the report underlined the need for authorities to proceed with the timely adoption and operationalisation of the proposed draft law. Lastly, in relation to the deposit insurance system, it was noted that further work is needed in order to address depositors' perception of an implicit deposit guarantee and to clarify the implementing rules to ensure that it can function credibly and effectively.

(d) Total loss-absorbing capacity standard for G-SIBs

The FSB in consultation with the BCBS finalised and published its proposed minimum standard for total loss-absorbing capacity (TLAC) in November 2015. This is a global standard for minimum amounts of TLAC to be held by G-SIBs. It has been designed to ensure that failing G-SIBs will have sufficient loss-absorbing and recapitalisation capacity available in resolution for authorities to implement orderly resolution that minimises the impact on financial stability, maintains the continuity of critical functions, and avoids exposing public funds to loss.

The TLAC standard defines a minimum requirement for the instruments and liabilities that should be readily available for bail-in within resolution at G-SIBs, but does not limit authorities' powers under the applicable resolution law to expose other liabilities to loss through bail-in or the application of other resolution tools. Under this standard, G-SIBs will be required to meet the TLAC requirement alongside the minimum regulatory requirements set out in the Basel III framework.

The FSB gives a role to the BCBS to specify this provision of TLAC and investments to TLAC, including a prudential treatment for non-G-SIBs when the consultative paper on TLAC was published. As a part of this role, the consultative paper on TLAC Holdings[64] sets out its proposed prudential treatment of banks' investments in TLAC. It is applicable to all banks subject to the Basel standards, including both G-SIBs and non-G-SIBs.

The proposed treatment is for banks to deduct from their regulatory capital their holdings of TLAC instruments,

[64] https://www.bis.org/bcbs/publ/d342.pdf.

subject to thresholds. It also addresses the treatment of holdings of instruments that rank pari passu to TLAC in the creditor hierarchy. The objective of the proposed treatment is to support the TLAC regime by reducing the risk of contagion if a G-SIB should enter resolution. The TLAC regime also necessitates changes to Basel III to specify how G-SIBs must take account of the TLAC requirement when calculating their regulatory capital buffers. In particular, any Common Equity Tier 1 that is being used to meet the TLAC requirement cannot be used to meet the regulatory capital buffers. The proposed changes to Basel III to give effect to this requirement are set out in the consultative document.

While IIFS are currently not large enough to have global systemic importance, there is a presence of domestic systemically important banks (D-SIBs) within some Islamic finance jurisdictions. In addition, some G-SIBs operate Islamic banking windows in various jurisdictions. Furthermore, although the aforementioned TLAC requirements are of primary interest to G-SIBs, some national authorities may extend this to D-SIBs. Given the potential to read across to D-SIBs and other firms, this standard may be of interest to non G-SIBs. The main implication of the standard, if applied to any IIFS, is that they would need to raise additional financing that qualifies for inclusion in TLAC and/or convert existing long-term financing into TLAC financing instruments.

(e) Joint Forum: Credit risk management across sectors

In the past year, the Joint Forum under the auspices of its parent committees, the BCBS, IOSCO and the IAIS, published a report on cross-sectoral credit risk management, as part of its work to address cross-sector risks or gaps between the three supervised sectors and to provide insight and guidance into key cross-sectoral prudential issues.

The Joint Forum report, Developments in Credit Risk Management across Sectors: Current Practices and Recommendations, published in June 2015, provides insight into the current supervisory framework for credit risk, the state of credit risk management at financial institutions, and the implications for the supervisory and regulatory treatments of credit risk.

The report is based on a survey conducted by the Joint Forum with supervisors and firms globally, in the three sectors of banking, securities and insurance, to understand the current state of credit risk management given the significant market and regulatory changes that have taken place since the 2008 financial crisis. Some of the significant themes that were identified from the surveys include: (i) increased credit risk due to "search for yield" and higher risk tolerance behaviours of firms resulting from the prevailing lower interest rate environment; (ii) over-the-counter (OTC) derivatives becoming a significant source of credit risk at financial institutions across sectors; and (iii) a shift in and concentration of credit risk to central counterparties (CCPs).

In addition to the aforementioned sources, other significant sources of credit risk emerging from the surveys include credit risk arising from lending, including traditional bank lending and direct lending by non-banks. In light of this finding, it is worth noting that non-bank financial intermediaries and other financial intermediaries in several jurisdictions have exhibited positive growth rates since the GFC. For example, in the ASEAN region, non-bank financial intermediaries account for one-third of the total assets in the financial system. While the financial systems in the region still remain bank-dominant, there is a growing shift towards non-bank financial intermediaries. This increasing role of non-bank financial intermediaries warrants greater attention in credit risk management for this sector, which is an area that has not been addressed sufficiently within Islamic finance regulation.

Loans to the corporate sector were also noted as one of the main sources of credit risk – in particular, loans to SMEs, which pose a huge challenge in managing credit risks. In this context, the increasing focus on SMEs in financial inclusiveness initiatives requires a closer look at credit risk arising from Islamic financing provided to SMEs, with an attention to the risk mitigation techniques that IIFS can adopt to mitigate against this risk.

Based on its analysis of the responses and subsequent discussions with firms, the Joint Forum presented several recommendations for consideration by supervisors, including the need for supervisors to be cognisant of the growth in risk-taking behaviour due to the current low return environment and the resultant need for institutions to have appropriate risk management processes. The Forum also cautioned against over-reliance on internal models for credit risk management and advocating authorities to evaluate simple measures in conjunction with more sophisticated modelling. This is less relevant to the IFSI, since the majority of IIFS use standardised approaches for the calculation of capital adequacy. Also of note is the ongoing revisions to the standardised approaches to credit risk management by the BCBS, which is expected to substantially improve the Standardised Approach (SA) for credit risk as a suitable alternative and complement to internal models.

2.1.2 Basel Committee on Banking Supervision

Since the publication of the IFSB IFSI Stability Report 2015, the BCBS has finalised and issued a number of standards which were already in development at the time of the 2015 report and were discussed in that report. This section looks at selected new standards and guidelines issued by the BCBS following the publication of the 2015 report.

The BCBS report, Implementation of Basel Standards,[65] updated G-20 leaders on progress in implementing the Basel III regulatory reforms by 27 of its member jurisdictions. It summarises the outcomes from the Regulatory Consistency Assessment Programme (RCAP), which comprises three parts: (i) monitoring the progress in adopting Basel III standards; (ii) assessing the consistency of national or regional banking regulations with the Basel III standards; and (iii) analysing the prudential outcomes that are produced by those regulations. According to this report, all its members had implemented Basel risk-based capital regulations by end-2013, and as of September 2015 all but two members had published final regulations to implement the liquidity coverage ratio (LCR) requirements, the phase-in of which began in January 2015.

The BCBS has also continued to publish several RCAP reports in which domestic regulations are reviewed to assess their degree of consistency with the minimum Basel III capital and liquidity standards. In 2015, the BCBS has concluded reviews of capital and liquidity regulations in the Hong Kong SAR, India, Mexico, South Africa and Saudi Arabia. Saudi Arabia is the first country with a significant Islamic banking sector to have undergone a RCAP review.

Moreover, some consultative documents discussed in the last IFSI Stability Report have been finalised by BCBS. These documents are: Corporate Governance Principles for Banks,[66] of July 2015 (the changes from the consultative paper are on the role of the board, board committee responsibilities – increased focus on whistleblowing), and Guidelines for Identifying and Dealing with Weak Banks,[67] of July 2015.

(a) Revisions to the Securitisation Framework

After two rounds of consultation, in December 2012 and December 2013, and two quantitative impact studies, the BCBS published its Revisions to the Securitisation Framework in December 2014. The revisions aim to address a number of shortcomings of securitisation capital requirements, including mechanistic reliance on external ratings, lack of risk sensitivity, cliff effects and insufficient capital for certain exposures in the Basel II securitisation framework and to strengthen the capital standards for securitisation exposures held in the banking book. It will come into effect in January 2018 as a part of the Basel III regime.

The most significant revisions with respect to the Basel II securitisation framework relate to changes in: (i) the hierarchy of approaches which reduces reliance on external ratings; (ii) the risk drivers used in each approach; and (iii) the amount of regulatory capital banks must hold for exposures to securitisations (i.e. the framework's calibration).

The revised Basel III securitisation framework represents a significant improvement to the Basel II framework in terms of reducing the complexity of the hierarchy and the number of approaches. Under the revisions there would be only three primary approaches, as opposed to the multiple approaches and exceptional treatments allowed in the Basel II framework. The revised hierarchy of approaches in the revised framework for securitisation exposures is:

1. Securitisation Internal Ratings-based Approach
2. Securitisation External Ratings-based Approach
3. Securitisation Standardised Approach.

In December 2013, the IFSB published IFSB-15: Revised Capital Adequacy Standard for IIFS, which adopts key Basel III proposals on capital components and macroprudential tools, with necessary adaptations for IIFS including securitisation. Since the products of IFSI are asset-backed, with resecuritisation generally impermissible, structuring of Sharī'ah-compliant securitisation products is relatively less complex. The *sukūk* market has grown rapidly over the last few years in terms of size, numbers and sophistication. While IFSB-15 covers the treatment of *sukūk* and Sharī'ah-compliant securitisation in detail, the IFSB will consider making adjustments to this standard, where needed, as a part of a new project on capital adequacy targeted to commence in 2017.

(b) Capital Floors – consultative document

The BCBS issued its consultative paper, Capital Floors: The Design of a Framework Based on Standardised Approaches,[69] in December 2014. The proposed floor would replace the existing transitional capital floor based on the Basel I framework.

The objectives of capital floors include:

- preventing undue optimism in bank modelling practices, thereby ensuring that modelled capital requirements do not fall below a prudent level;
- mitigating model risk due to such factors as incorrect model specification, measurement error, data limitations and structural changes that may not be captured in historical data;
- addressing incentive-compatibility issues, as banks face incentives to use overly optimistic internal models to reduce risk-weighted assets (RWAs) and thereby maximise return on equity;

[65] www.bis.org/bcbs/publ/d345.pdf.
[66] www.bis.org/bcbs/publ/d328.pdf.
[67] www.bis.org/bcbs/publ/d330.pdf.
[68] www.bis.org/bcbs/publ/d303.pdf.
[69] www.bis.org/bcbs/publ/d306.pdf.

- improving comparability by providing a standardised assessment of risk which can be compared against internal model-based outcomes; and
- constraining variation in model-derived RWAs that arises from differences in bank and supervisory practices, thereby improving the comparability of RWAs across banks and over time.

The framework will be based on the Basel II/III standardised approaches, and allows for a more coherent and integrated capital framework. The Basel II framework introduced a capital floor as part of the transitional arrangements for banks using the internal ratings-based (IRB) approach for credit risk and/or an Advanced Measurement Approach (AMA) for operational risk, but there was concern that the changes to capital charges made in Basel 2.5 and Basel III had not been reflected in the capital floor.

Two options have been proposed in the consultative paper. The first approach ("Option 1") is to adjust the floor for differences in the treatment of provisions, which would take the form of an adjustment to the numerator of the capital ratio. This would reverse the additions or deductions from the IRB approach to capital resources and apply the Standardised Approach treatment to provisioning. An alternative approach for adjusting for differences in provisioning would be to adjust RWAs ("Option 2"). More specifically, the relevant provisions would be converted to an "RWA equivalent" and be added to or removed from a bank's RWAs when calculating its capital floor.

In IFSB-15, credit risk is measured according to the Standardised Approach of Basel II and operational risk measurement does not include the AMA. Because of this, there is no capital floor requirement for IIFS in the capital adequacy framework proposed by the IFSB. However, some IIFS have been growing in size and complexity and may use the advanced, model-based approaches for measurement of their credit and market risk, though this change will be impacted by the new Basel rules on the Standardised Approach for credit risk (see below). As mentioned, the IFSB work plan for 2016–2018 includes a revision of IFSB-15, which will incorporate the study of advanced approaches and capital floors for their possible application to IIFS.

(c) Revisions to the Standardised Approach for Credit Risk – second consultative document

As part of the BCBS's broader work on reducing variability in RWAs, a second consultative paper, Revisions to the Standardised Approach for Credit Risk,[70] was issued in December 2015. This second consultative paper is the BCBS's broader review of the capital framework to balance simplicity and risk sensitivity, and to promote comparability by reducing variability in RWAs across banks and jurisdictions taking into account the comments received after the first consultative draft.

The second proposal differs in several ways from the first proposal published by the BCBS in December 2014. These changes are set out in Table 2.1.2.1.

Table 2.1.2.1 Key Changes in the Second Consultative Paper

BCBS Approach	Key Changes from First Consultative Paper
The earlier proposal set out an approach that removed all references to external credit ratings and assigned risk weights based on a limited number of alternative risk drivers.	The BCBS has decided to reintroduce the use of ratings, in a non-mechanistic manner, for exposures to banks and corporates. The revised proposal also includes alternative approaches for jurisdictions that do not allow the use of external ratings for regulatory purposes.
The BCBS has decided not to use a debt service coverage ratio as a risk driver given the challenges of defining and calibrating a global measure that can be consistently applied across jurisdictions	The proposed risk weighting of real estate loans has also been modified, with the loan-to-value ratio as the main risk driver.
The BCBS is considering the exposures to multilateral development banks, retail and defaulted exposures, and off-balance sheet items as part of a broader and holistic review of sovereign-related risks. The credit risk standardised approach treatment for sovereigns, central banks and public-sector entities is not within the scope of these proposals.	This consultative document also includes proposals for exposures to multilateral development banks, retail and defaulted exposures, and off-balance sheet items.

[70] www.bis.org/bcbs/publ/d347.pdf.

The key revisions to the Standardised Approach for credit risk are set out in Table 2.1.2.2.

Table 2.1.2.2 The Main Proposed Changes to the Standardised Approach for Credit Risk

Exposure	Current Standardised Approach	Proposed Revisions
Bank exposures	Risk-weighted by reference to the bank's external credit rating or that of its sovereign of incorporation.	Exposures are risk-weighted based on the following hierarchy: (a) External Credit Risk Assessment Approach (ECRA) with due diligence assessment: for rated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes. (b) Standardised Credit Risk Assessment Approach (SCRA): for unrated exposures of banks incorporated in jurisdictions that allow the use of external ratings for regulatory purposes; and for all exposures of banks incorporated in jurisdictions that do not allow the use of external ratings for regulatory purposes. Three grades for assigning bank exposures: • Grade A: 50% • Grade B: 100% • Grade C: 150%
Corporate exposures	Risk-weighted by reference to the borrowing firm's external credit rating. For unrated exposures, a flat risk weight is applied.	Risk weights based on the two different approaches for corporate exposures, depending on whether a jurisdiction allows the use of external ratings for regulatory purposes. (a) Use of external ratings for regulatory purposes: • For rated corporate exposures: A bank would determine the "base" risk weight of the exposure according to a look-up table based on external ratings. Due diligence analysis may result in the application of a higher risk weight than that determined by the external rating. • For unrated corporate exposures: As in the current approach, a bank would assign a 100% risk weight. (b) No use of external ratings for regulatory purposes: • For "investment-grade" corporate exposures: A bank would assign a 75% risk weight to corporate exposures to counterparties that meet the definition of "investment grade". • For all other corporate exposures: A bank would assign a 100% risk weight (unless the exposure is in default). In addition, a lower risk weight of 85% is proposed for exposures to SMEs. For specialised lending exposures to corporates, where issue-specific external ratings are either not available or not allowed for regulatory purposes in a jurisdiction, it is proposed: • For object and commodity finance exposures: A flat risk weight of 120% would apply (irrespective of the counterparty's risk weight); and • For project finance: A 150% risk weight would apply in the pre-operational phase, and a 100% risk weight in the operational phase

Exposure	Current Standardised Approach	Proposed Revisions
Subordinated debt, equity and other capital instruments	Investments in equity or regulatory capital instruments issued by banks or securities firms are risk-weighted at either 100% or 250%, unless a deduction applies.	For equity holdings that are not deducted: A 250% risk weight. Given that significant equity exposures to financial institutions below the deduction threshold are required to be risk-weighted at 250%, it follows that insignificant equity exposures to financial institutions as well as equity exposures to non-financial institutions should not be subject to a higher risk weight. For subordinated debt and capital instruments other than equities below the threshold deductions: A 150% risk weight.
Retail exposures	A 75% risk weight to retail exposures that meet the regulatory retail criteria. However, the criteria are in some cases vague and open to interpretation.	Considering whether to maintain the 75% risk weight applicable to regulatory retail exposures. Exposures to individuals that do not meet all of the criteria for a regulatory retail portfolio would be categorised as "other retail exposures". It is proposed to apply a 100% risk weight to other retail exposures.
Claims secured by real estate	Two exposure categories in which the risk-weight treatment is based on the collateral provided to secure the relevant exposure: exposures secured by residential real estate receive risk weights of 35%; and exposures secured by commercial real estate receive risk weights of 100%.	To increase risk sensitivity and harmonise global standards, risk weights ranging from 25% to 100% based on the loan-to-value (LTV) ratio for exposures secured by residential real estate. A flat risk weight of 100% in the current Standardised Approach for exposures secured by a mortgage on commercial real estate.
Credit risk mitigation	Substitution approach: (i) Guarantees and credit derivatives; and (ii) Financial collateral (Simple Approach). • Reduce exposure amount through the use of haircuts: (i) Financial collateral (Comprehensive Approach); and (ii) On-balance sheet netting of deposits and loans	Guarantees: Eligible universe of credit protection providers. Credit derivatives: Exposures below materiality threshold risk-weighted at 1250% instead of deducted from capital. On balance sheet netting: No change

After the finalisation of the new enhancements and significant developments related to the Standardised Approach for credit risk by BCBS, the IFSB review of its standard IFSB-15, already mentioned, will also consider how to reflect these developments, taking into account the specific characteristics of credit risk exposure of IIFS' products under the Standardised Approach for credit risk. BCBS's proposal is an attempt to strengthen the link between the Standardised Approach and the IRB approach in order to enhance comparability of capital requirements across banks. Currently, the IFSB only provides the Standardised Approach for credit risk. In the process of revising IFSB-15 to reflect recent developments, it will be useful to analyse and evaluate the IRB models in the light of the current status of IIFS. Such an IRB model may be useful for IIFS, especially in relation to their risk exposures to SMEs.

(d) Revised Pillar 3 Disclosure Requirements

The BCBS finalised and issued Revised Pillar 3 Disclosure Requirements[71] in January 2015. The IFSI Stability Report 2015 has provided information about the consultative paper. The revisions to the disclosure requirements address shortcomings in Pillar 3 of the Basel framework. The revised disclosure requirements will enable market participants to better compare banks' disclosures of RWAs. The revised requirements, which will take effect from year-end 2016, supersede the existing Pillar 3 disclosure requirements first issued as part of the Basel II framework in 2004 and the Basel 2.5 revisions and enhancements introduced in 2009. The most significant revisions with respect to the previous Pillar 3 disclosure requirements relate to the use of templates for quantitative disclosure accompanied with definitions, some of them with a fixed format. This aims to enhance comparability of banks' disclosures, both across banks and over time.

Compared to the consultative version, the key changes are as follows:
- rebalancing the disclosures required quarterly, semi-annually and annually;
- streamlining the requirements related to disclosure of credit risk exposures and credit risk mitigation techniques; and
- clarifying and streamlining the disclosure requirements for securitisation exposures.

Following its revisions of Pillars 1 and 2 of the capital adequacy framework for IIFS through the issuance of IFSB-15: Revised Capital Adequacy Standard for IIFS and IFSB-16: Revised Guidance on Key Elements in the Supervisory Review Process of IIFS in 2013 and 2014, respectively, the IFSB will commence a new project to revise its earlier standard on the Pillar 3 disclosure requirement, currently IFSB-4: Disclosures to Promote Transparency and Market Discipline for IIFS. The revision will take into account the specific features of the IIFS in addition to the updated disclosure requirements suggested by the BCBS. The new standard will also add the consumer protection dimension of Sharīʽah-compliant products and services offered by the IIFS. Market discipline has long been recognised as a key objective of financial-sector regulation by the international standard-setting bodies and regulatory and supervisory authorities. The need for transparency is also an important consideration for IIFS, which must comply with Sharīʽah rules and regulations. Improving disclosure is key to provide the RSAs and the public with a better understanding of IIFS' strategies and relevant risks.

(e) Interest Rate Risk in the Banking Book – Consultative Document

The BCBS published a consultative document on the risk management, capital treatment and supervision of interest rate risk in the banking book (IRRBB)[72] in June 2015. It has two main objectives: (i) to help ensure that banks have appropriate capital to cover potential losses from exposures to changes in interest rates, which is particularly important in the light of the current exceptionally low interest rate environment in many jurisdictions; and (ii) to limit capital arbitrage between the trading book and the banking book, as well as between banking book portfolios that are subject to different accounting treatments.

Diagram 2.1.2.1 shows two options for the capital treatment of interest rate risk in the banking book in the consultative paper.

The BCBS proposal for IRRBB would create a capital requirement for this risk, within Pillar I of the Basel regime. IIFS are not exposed to interest rate risk as such, but an increase in benchmark rates may result in IAHs having expectations of a high rate of return. Islamic banks are thus subject to rate of return risk, which, like interest rate risk, has been treated within Pillar II. It will be important to consider how rate of return risk should be treated; this is likely to involve a further amendment to IFSB standards on this subject during the IFSB Strategic Performance Plan (SPP) 2016–2018.

[71] www.bis.org/bcbs/publ/d309.pdf.
[72] www.bis.org/bcbs/publ/d319.pdf.

Diagram 2.1.2.1 Two Options for the Regulatory Treatments of IRRBB

Standardised Pillar 1 (Minimum Capital Requirements) Approach	• Measures for calculating minimum capital requirements, which would have the benefit of promoting greater consistency, transparency and comparability, thereby promoting market confidence in banks' capital adequacy and a level playing field internationally. • Using an economic value of equity (EVE) measure, interest rate risk exposure is measured against several interest rate shock scenarios.
An Enhanced Pillar 2 Approach (which also includes elements of Pillar 3 – Market Discipline)	• Includes quantitative disclosure of IRRBB based upon the proposed Pillar 1 approach, which would better accommodate differing market conditions and risk management practices across jurisdictions. • Represents a new hybrid intersection between a capital requirement (Pillar 1) and a supervisory review process (Pillar 2) and would have served to promote greater consistency, transparency and comparability.

(f) Capital Treatment for "Simple, Transparent and Comparable" Securitisations – Consultative Document

In November 2015 the BCBS released a consultative document, Capital Treatment for "Simple, Transparent and Comparable" Securitisations.[73] This proposal builds on the revised capital standards issued by the BCBS in December 2014 which was discussed in section (a) above under "Revisions to the Securitisation Framework".

The criteria for identifying simple, transparent and comparable securitisations ("STC criteria")[74] were published by the BCBS and the IOSCO in July 2015. The July 2015 STC criteria are designed to mitigate securitisation risks, including uncertainty related to asset risk, structural risk, governance and operational risk. Transactions that comply with these criteria should therefore have lower structural and model risk. With this consultative paper the BCBS proposes to supplement the July 2015 STC criteria with additional criteria for the specific purpose of differentiating the capital treatment of STC from that of other securitisation transactions. The additional criteria would, for example, exclude transactions in which the standardised risk weights for the underlying assets exceed certain levels.

The BCBS is proposing to reduce minimum capital requirements for such STC securitisations by reducing the risk-weight floor for senior exposures, and by rescaling risk weights for other exposures. A range for the potential reduction in capital charges is suggested. Three risks are mapped in the securitisation process: (i) generic criteria relating to the underlying asset pool (asset risk); (ii) transparency around the securitisation structure (structural risk); and (iii) governance of key parties to the securitisation process (fiduciary and servicer risk).

As mentioned, IIFS have limited securitisation exposures and these are mainly on *sukūk*. The proposed project to revise IFSB-15 will include the capital requirements for "simple, transparent and comparable" securitisation for IIFS.

(g) Guidance on Accounting for Expected Credit Losses – Consultative Document

The consultative document Guidance on Accounting for Expected Credit Losses[75] was issued in February 2015. It outlines supervisory expectations regarding sound credit risk practices associated with implementing and applying an expected credit loss (ECL) accounting framework, in the light of the global transition to such a framework. The revised guidance aims to promote high-quality, robust and consistent implementation of ECL accounting frameworks across all jurisdictions.

The BCBS has structured 11 principles for supervisory guidance on accounting of expected credit losses. The principles provide supervisory requirements on how banks should utilise common elements of the credit risk management process that allow high-quality and robust assessments and measurements of ECL, and promote consistency in the assessment and measurement of credit risk, development of accounting estimates and assessments of capital adequacy.

From the IFSI perspective, the IFSB issued its Core Principles for Islamic Finance Regulation (Banking Segment) in April 2015. In CPIFR 20, "Problem Assets,

[73] https://www.bis.org/bcbs/publ/d343.pdf.
[74] https://www.bis.org/bcbs/publ/d332.pdf.
[75] www.bis.org/bcbs/publ/d311.pdf

Provisions and Reserves", the IFSB requires expected losses to be taken into account for prudential purposes.

(h) Minimum Capital Requirements for Market Risk

A new standard, Minimum Capital Requirements for Market Risk,[76] published in January 2016, replaces the existing minimum capital requirements for market risk in the global regulatory framework, including amendments made after the June 2006 publication of Basel II: International Convergence of Capital Measurement and Capital Standards – Comprehensive Version. The fundamental review of the market risk standard is a core component of the Basel III reform package. The new market risk framework will take effect in 2019. The revised standard on minimum capital requirement on market risk is designed to reduce incentives for arbitrage between the regulatory banking and trading books, while continuing to respect banks' risk management practices.

The key enhancements include:

(i) Additional guidance on the appropriate contents of the trading book. The definition of the trading book is supplemented with a list of instruments presumed to be in the trading book. Importantly, a bank must receive explicit supervisory approval for any deviations from this list of instruments.

(ii) Reducing the ability to arbitrage the boundary. A strict limit on the movement of instruments between the banking book and trading book is introduced. If the capital charge on an instrument is reduced as a result of switching (in the rare instances where this is allowed), the difference in charges measured at the point of the switch is imposed on the bank as a fixed, additional (and disclosed) Pillar 1 capital charge.

(iii) Enhanced supervisory powers and reporting requirements. The revised standard provides supervisors with the discretion to initiate a switch from the trading book to the banking book, or vice versa, if an instrument is deemed to be improperly designated. Banks must also prepare, evaluate and make available to supervisors reports on their boundary determination and compliance, inventory ageing, daily limits, intraday limits (for banks with active intraday trading) and assessments of market liquidity.

(iv) Clearer treatment of internal risk transfers across the regulatory boundary. The current boundary specifies the treatment of internal risk transfers of credit risk but is silent with respect to other risk classes. To promote consistency and comparability in regulatory practices across jurisdictions, limits are introduced on the internal risk transfers of equity risk and interest rate risk from the banking book to the trading book for regulatory capital purposes.

IIFS in general have limited exposures to market risk, reflecting the fact that they do not run substantial trading books. Because of this, IFSB-15 provides only for the Standardised Approach to market risk, but does set out how this risk should be assessed across a range of Islamic contracts. As mentioned, the IFSB work plan for 2016–2018 includes a revision of IFSB-15, which will incorporate the study of capital requirements for market risk on the IIFS.

2.1.3 International Association of Insurance Supervisors

The year 2015 saw the International Association of Insurance Supervisors focusing on several key issues relating to capital requirements, liquidity and conduct of business. This is in addition to the revisions made to select Insurance Core Principles.

(a) Insurance Capital Standard: Progress on Development of Basic Capital Requirements (BCR) and Higher Loss Absorbency (HLA)

In October 2014, the IAIS concluded the development of the first-ever global insurance capital standard – Basic Capital Requirements for Globally Systemically Important Insurers. Reporting of BCR by the G-SIIs took effect in early 2015. In October 2015 the IAIS subsequently adopted the Higher Loss Absorbency Requirement. This initial version of HLA has been endorsed by both the Executive Committee of the IAIS and the FSB. This adoption signifies the achievement of the second phase of the IAIS' initiative in developing a capital standard that will apply to all internationally active insurance groups – the Insurance Capital Standard, which is due to be adopted by the end of 2019.

When the IAIS published its initial assessment methodology and policy measures for G-SIIs in July 2013, the policy measures included the HLA requirement. The main objective of this requirement is to reduce the probability and impact on the financial system of the failure of G-SIIs. However, this may only be done upon completion of the BCR. The first phase, which was the development of this BCR, was completed in 2014. Under the ICS, all G-SIIs are required to hold capital no lower than BCR plus HLA requirements. The BCR ratio is calculated by dividing total qualifying capital resources[77] by required capital.[78] For HLA calculation, the required

[76] https://www.bis.org/bcbs/publ/d352.pdf.
[77] Total qualifying capital resources are determined on a consolidated group-wide basis for all financial and material non-financial activities and are classified as either core or additional capital.
[78] Required capital is calculated on a consolidated group-wide basis for all financial and material non-financial activities.

capital formula builds on the foundation of the BCR required capital formula, which is the sum over a number of products of an exposure multiplied by a factor. The combination of BCR and HLA will provide a complete group-wide capital requirement. BCR reporting, which started at the beginning of 2015, applies to all group activities, including non-insurance activities, of G-SIIs, and sets the foundation for the HLA requirement. The combination of BCR and HLA is captured by this formula:

$$\text{BCR + HLA ratio} = \frac{\text{Total qualifying capital resources (for BCR and HLA)}}{\text{BCR + HLA required capital}}$$

The approved HLA requirement, which will take effect at the beginning of 2016, shall be reported on a confidential basis to the group-wide supervisors. The reports, which will also be shared with the IAIS, shall be used for monitoring purposes to improve the HLA. The IAIS annually reviews the calibration of the HLA and BCR, and recommends any changes to the G-SII Assessment Methodology that might be necessary and the definitions of non-traditional and non-insurance activities. A second ICS consultation document is expected to be prepared in mid-2016, with a final target to approve ICS Version 1.0 (Confidential Reporting) in 2017. Under ICS Version 1.0, the confidential reporting shall be based on the identified two valuation approaches as well as a standard method for calculating the ICS capital requirement.

ICS Version 1.0 is the first interim version of ICS prior to achieving the IAIS' ICS Ultimate Goal. The second interim version of ICS is ICS Version 2.0 (for adoption within ComFrame), where the goal is the delivery of an ICS framework that is fit for implementation for supervisors where there is an improved level of comparability compared to ICS Version 1.0. ICS Version 2.0 may still include two valuation approaches which aspire to reduce differences in the valuation figures. This second version also allows the use of internal models (full or partial), an external model, and variations of the standard method in calculating the ICS capital requirement.

The ICS Ultimate Goal, the date of which is yet to be confirmed, is for supervisors to achieve comparable, substantially the same, outcomes across jurisdictions. The lessons learned during the interim phases of ICS Version 1.0 (Confidential Reporting) and ICS Version 2.0 (for adoption within ComFrame) shall be used to absorb lessons for improvement prior to achieving the final goal.

The IFSB, in charting its work plan in SPP, 2016–2018, has taken an interest in the development of the ICS. IFSB-11: Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings has thus far been the only standard on capital for *takāful* operators, and mainly addresses capital requirements at the individual entity level. For the IFSB to embark on developing guidance on group solvency regimes, a proper complementary document needs to be benchmarked against the initiatives of the IAIS. Hence, any revision to IFSB-11 in light of the ICS shall not be expected to begin until the ICS of the IAIS is nearing completion.

(b) Revision of Selected Insurance Core Principles

Since the IAIS's adoption of the newly revised Insurance Core Principles in 2011, individual core principles have subsequently been amended to reflect best practices of the industry. The amendments address changes to the insurance sector and supervisory requirements, mostly as a result of self-assessment and peer review (SAPR). These updates are expected to be conducted consistently as the IAIS performs a full review of the ICPs. The most recent changes were adopted on 12 November 2015, when six ICPs were updated. During this SAPR, it was observed that ICP 23 did not offer sufficient clarity regarding the expectations of how group-wide supervision should be performed. Duplications with other ICPs were also detected, which made implementation difficult for the supervisors. A revision to ICP 23 was proposed, which led to the need to review a few other ICPs in order to strengthen supervisory approaches to group-wide supervision, as well as requirements on the Head of the Group. The affected ICPs are ICP 4 (Licensing), ICP 5 (Suitability of Persons), ICP 7 (Corporate Governance), ICP 8 (Risk Management and Internal Control) and ICP 25 (Supervisory Cooperation and Coordination), which were revised accordingly.

The changes in ICP 23 have seen the ICP being substantially condensed into only three standards, concentrating on identifying the group, defining the scope of supervision, and ensuring that no gaps in supervision occur. To reduce complexity as well as duplication, any requirements that already appear or, more pertinently, belong under another thematic ICP have been removed. All these revisions have been successfully adopted by the IAIS in its 2015 Annual General Meeting.

With the issuance of IFSB-17: Core Principles for Islamic Finance Regulation (Banking) in April 2015, the IFSB is embarking on the next phase of Core Principles for Islamic Finance Regulation – in particular, the development of Core Principles for the Islamic Capital Market in 2016. With the revisions of other ICPs by the IAIS expected to continue over the next two years in different stages, it is hoped that the revisions shall be finalised by the time the IFSB begins its work on the third phase of Core Principles for Islamic Finance Regulation (*Takāful*). As per the new IFSB SPP 2016–2018, this project is tentatively targeted for commencement in 2018.

(c) Development in Other Areas

The following documents were issued, covering conduct of business, supervisory colleges and liquidity guidance.

(i) (Application Paper on Approaches to Conduct of Business Supervision (4 November 2014)

This application paper was prepared to provide guidance to regulatory authorities on supervision of institutions' conduct of business. The initiative came about after discovering that systemic risk may not be caused solely by an individual institution's financial and capital management. Poor conduct of business and unfair treatment of policyholders may contribute to the eventual fall of an institution. Although IFSB-9: Guiding Principles on Conduct of Business for Institutions Offering Islamic Financial Services lists seven principles which should ideally be applied by IIFS, this Application Paper provides further guidance for the *takāful* industry – namely, in the areas of fair treatment policies and procedures, pre- and post-sale process and policy servicing, which are not spelled out in IFSB-9. As envisaged in the SPP 2016–2018, further work in the area of consumer protection is hoped to extend guidance in these areas.

(ii) Issues Paper on Conduct of Business in Inclusive Insurance (11 November 2015)

Since the IAIS started its "access agenda" in 2006 via collaborative work with Consultative Group to Assist the Poor (CGAP), various papers have been issued covering issues pertaining to microinsurance. Two Issues Papers and one Application Paper were adopted[79] in 2007, 2010 and 2012, respectively. This new Issues Paper is an initiative to continue the efforts made, this time focusing on the conduct of business. It provides the industry stakeholders a view of how customers' protection should be made before and after a contract is entered into. The paper recommends that supervisors have a comprehensive understanding of inclusive insurance, to understand the challenges arising from supervising the institutions, as well as to pay attention to particularities and characteristics of each jurisdiction's insurance sector in order to provide consumer protection. Particular attention should be paid to consumer protection at the various levels of the product life cycle – that is, product development, distribution, customer acceptance, disclosure of information, premium collection, claim settlements and complaints handling. Supervisors are also advised to give due consideration to the payments and claims settlement processes, since their efficiency and effectiveness could affect perceptions of inclusive insurance objectives. In expanding its supervisory efforts and guidance, in November 2015, the IAIS jointly worked together with the IFSB to publish Issues in Regulation and Supervision of the *Microtakāful* (Islamic Microinsurance) Sector. This paper charts the direction for further work to be done in critical areas of *takāful* – namely, in the separation of funds, solvency and capital adequacy framework, investment policies and Sharī'ah compliance requirements

(iii) Issues Paper on Conduct of Business Risk and its Management (23 November 2015)

This Issues Paper is intended to provide guidance to supervisors in making their own risk-based assessments of the conduct of risks in their business environment. The paper discusses the background and current practices, provides examples that may be applicable to the supervisors, and describes the regulatory challenges relevant to the business risk. Given that different jurisdictions interpret conduct of business risks differently, this paper describes conduct of business risk as follows: "Conduct of business risk can be described as the risk to customers, insurers, the insurance sector or the insurance market that arises from insurers and/or intermediaries conducting their business in a way that does not ensure fair treatment of customers." The central focus of this paper is on providing a comprehensive understanding and assessment of a sound risk culture and raising awareness of conduct of business risk, with a specific focus on retail customers. It gives an idea of the areas of insurance markets and the insurance business model which may give rise to unfair customer treatment. It also highlights the supervisory areas requiring the attention of RSAs in assessing business conduct in their respective environments. The paper serves as a good reference point for the IFSB's work plan for *takāful* in 2016–2018 – namely, in identifying the areas requiring strict observation of market discipline in order to protect the participants.

2.1.4 International Organization of Securities Commissions

(a) IOSCO's Strategic Direction, 2015 to 2020

In May 2015, IOSCO published a document announcing its strategic direction for the five years to 2020. IOSCO reported that its goal to 2020 would be to reinforce its position as the key global reference point for markets regulation. This is to be achieved through 43 initiatives spanning six priority areas, as outlined below:

[79] *Issues in Regulation and Supervision of Microinsurance (June 2007), Issues Paper on the Regulation and Supervision of Mutuals, Cooperatives and other Community-based Organisations in Increasing Access to Insurance Markets* (October 2010) and *Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets (October 2012).*

1. research and risk identification;
2. standard setting and developing guidance;
3. implementation monitoring;
4. capacity building;
5. cooperation and information exchange; and
6. collaboration and engagement with other international organisations.

As part of its action plans, IOSCO's research works would focus more broadly on risks faced by member jurisdictions in the areas of investor protection as well as the fair, efficient and transparent functioning of markets arising from securities markets, technology and product development, which include the unintended consequences of changes or proposed changes in law and regulations. Apart from developing standards and guidance for the securities markets and promoting the implementation of IOSCO standards through monitoring and assessment, IOSCO also seeks to address the capacity-building needs of its members, particularly in the emerging markets. In regards to its last action plan to collaborate and cooperate with other standard-setting bodies, the IFSB will continue to seek closer collaboration with IOSCO in the area of the Islamic capital market.

(b) Statement on Addressing Regulation of Crowdfunding

In December 2015, IOSCO published a survey of regulatory responses to crowdfunding. In an accompanying statement, IOSCO said that it had not suggested a joint international approach to the oversight or supervision of crowdfunding, since a majority of the regulatory regimes are still in the infancy stage.

Nevertheless, IOSCO highlighted the following risks related to crowdfunding, additional to the common investment risks:

- eightened financial risks associated with start-up businesses;
- fraud, money laundering/terrorist financing;
- the potential failure of the crowdfunding platform itself;
- illiquidity;
- suitability/information asymmetry; and
- cross-border risks.

Among the measures that some regulators have undertaken to address these risks are:

- setting disclosure requirements for issuers and funding portals;
- requiring investor education and/or statements signed by investors acknowledging their understanding of risks;
- limiting the size of the investments made by an individual in each offering and in a given time frame; and
- requiring the appointment of a third-party custodian to hold investor assets.

The IFSB will monitor the development and application of crowdfunding as an alternative channel to capital raising and, similarly to IOSCO, will assess whether there could be future work in this area.

(c) Standards for the Custody of Collective Investment Schemes' Assets[80]

In 1996, IOSCO published Guidance on Custody Arrangements for Collective Investment Schemes ("1996 Paper"). Following the events of the 2008 GFC, IOSCO re-examined the 1996 Paper. In November 2015, it published the final report on Standards for Custody of CIS Assets, which set out eight standards divided into two sections that cover key aspects relating to the custody function, as well as the appointment and ongoing monitoring of custodians. The report also identified key risks associated with the custody of CIS assets where the standards, which are outlined below, offer ways to manage and mitigate these risks in the current global regulatory environment.

No.	Source	Details
1	Standard 1	The regulatory regime should make appropriate provision for custodial arrangements of the CIS.
2	Standard 2	CIS assets should be segregated from: • the assets of the responsible entity and its related entities; • the assets of the custodian/sub-custodian throughout the custody chain; and • the assets of other schemes and other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).
3	Standard 3	CIS assets should be entrusted to a third-party custodian that is functionally independent from the responsible entity.
4	Standard 4	The responsible entity should seek to ensure that the custody arrangements in place are disclosed appropriately to investors in the CIS offering documents or otherwise made transparent to investors.

[80] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD512.pdf.

No.	Source	Details
5	Standard 5	The responsible entity should use appropriate care, skill and diligence when appointing a custodian.
6	Standard 6	The responsible entity should, at a minimum, consider a custodian's legal/regulatory status, financial resources and organisational capabilities during the due diligence process.
7	Standard 7	The responsible entity should formally document its relationship with the custodian, and the agreement should seek to include provisions about the scope of the custodian's responsibility and liability.
8	Standard 8	Custody arrangements should be monitored on an ongoing basis for compliance with the terms of the custody agreement.

The above standards should also be applicable to the custody of ICIS assets. As indicated in IFSB-6: Guiding Principles on Governance for ICIS, ICIS are usually organised under two structures – that is, the Corporate Model and the Contractual Model. Under these models, if a depository performs the oversight role of the ICIS operations, the same party also performs the safekeeping of the ICIS assets. However, if the oversight role is conducted by either the board of directors or the trustee, the safekeeping of assets is usually entrusted to a custodian. In cases where the depository performs both the oversight role and safekeeping of the assets, it is crucial for the depository to ensure that the assets in its custody and any related transactions are Sharī'ah compliant.

(d) Peer Review of Regulation of Money Market Funds: Final report[81]

Money market funds (MMFs) invest in short-term securities and are generally regarded as low-risk/low-return investments. Following a request from the G-20 leaders, IOSCO conducted a peer review on progress regarding MMF regulatory reforms, and published the Peer Review of Regulation of Money Market Funds report ("Peer Review report") in September 2015. The report describes the implementation progress made by the 31 jurisdictions in adopting legislation, regulations and other policies in relation to MMFs, and covers the implementation progress for the reform areas addressed under IOSCO's Policy Recommendations for Money Market Funds report in 2012.

The IFSB is currently drafting a new standard – namely, the Guiding Principles on Disclosure Requirements for Islamic Capital Market Products ("ICM Standard") – with a target focus on *sukūk* and ICIS. It is proposed that the standard will cover disclosures for specialist ICIS such as MMF. The IFSB may make reference to the Peer Review report in formulating the ICM Standard. Some recommendations highlighted in the report included disclosures to investors, such as general product disclosures, disclosures in relation to valuation, and specific disclosure of the absence of a capital guarantee and the possibility of loss of principal.

(e) Thematic Review of the Implementation of Timeliness and Frequency of Disclosure to Investors According to Principles 16 and 26 of The Losco Objectives and Principles of Securities Regulation[82]

Timely and frequent disclosure of information material to investment decisions is critical for investor protection and for promoting fair, efficient and transparent markets. In July 2015, IOSCO released a report that sets out the findings of a Thematic Review ("Review") of the timeliness and frequency of disclosure by issuers and CIS under the Principles of Securities Regulation ("IOSCO Principles").

In relation to disclosures under Principle 16, dealing with disclosure by issuers of securities about financial results, risks, etc., the report mentioned differences around whether and when information is required to be disclosed, and that requirements varied according to the type of issuer and the type of information.

In relation to disclosures under Principle 26, dealing with disclosure by CIS, the Review discovered that all jurisdictions had in place timely disclosure requirements on value, risk–reward profile and costs of CIS, which were largely done by way of updates to prospectuses or other offering documents.

Similarly, the aspects discussed in the Review may be taken into consideration while the ICM Standard is drafted by the IFSB, as Principles 16 and 26 are applicable to *sukūk* and ICIS, respectively.

(f) Public Quantitative Disclosure Standards for Central Counterparties Report of the Committee on Payments and Market Infrastructures and the Board of IOSCO[83]

IOSCO, together with the Committee on Payments and Market Infrastructures (CPMI) (previously known as the

[81] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD502.pdf.
[82] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD498.pdf.
[83] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD475.pdf.

IOSCO, together with the Committee on Payments and Market Infrastructures (CPMI) (previously known as the Committee on Payment and Settlement Systems (CPSS)), published a document called Principles for Financial Market Infrastructures (PFMI) in December 2012. The document stated that financial market infrastructures (FMIs) should provide relevant information to participants, relevant authorities and the broader public. Principle 23 of the PFMI stipulates that FMI should provide minimum disclosure on "basic data" on transaction volumes and values, data on their financial condition, their financial resources to withstand potential losses, the timeliness of settlements and other performance statistics.

Public Quantitative Disclosure Standards for Central Counterparties ("Public Quantitative Disclosure Document") was published in February 2015, to complement Principles for Financial Market Infrastructures: Disclosure Framework and Assessment Methodology ("Disclosure Framework") of December 2012. The Public Quantitative Disclosure Document set out the public quantitative disclosure standards to be imposed on central counterparties and forms a common set of such "basic data" on transaction volumes and values, and a common minimum set of quantitative information on the financial condition, financial resources and performance of a CCP. These quantitative disclosures, together with the Disclosure Framework, form the minimum disclosures expected of CCPs under Principle 23 of the PFMI. By having these minimum disclosures, it will enable stakeholders, including authorities, participants and the public, to compare CCP risk controls and have a clear, accurate and full understanding of the risks associated with a CCP, among others.

FMIs such as CCPs also exist in the Islamic space and therefore the disclosure framework should be applicable to the ICM sector as well. Although the IFSB has no current standards relating to CCPs, there could be a possibility of work being done on this area in the future.

(g) A Comparison and Analysis of Prudential Standards in the Securities Sector[84]

In 2010, the Joint Forum (which brings together members from the BCBS, IOSCO and IAIS to address issues of common interest) released a report entitled Review of the Differentiated Nature and Scope of Financial Regulation. Among other things, the report highlighted their concerns about the lack of uniform global standards for capital adequacy within the securities and insurance sectors comparable to that in the banking sector.

The IOSCO Committee on the Regulation of Market Intermediaries conducted an examination of the existing major capital frameworks in effect within the securities sector and published the final report, entitled A Comparison and Analysis of Prudential Standards in the Securities Sector, in February 2015 ("2015 Report"). The report undertook a high-level comparative analysis of the key prudential/capital frameworks for securities firms, highlighting similarities, differences and gaps.

The 2015 Report discussed the two key approaches to prudential requirements: one based on the Basel approach (like the Capital Requirements Directive in the EU) and focusing mainly on solvency; and a Net Capital Requirement (NCR) approach, which focuses on ensuring that securities firms have sufficient liquid balance sheet assets so that they can be wound down in an orderly fashion and without imposing losses on their customers. The comparison proved challenging, but has identified a number of significant issues which might be addressed in any future IOSCO work on capital standards.

The IFSB will follow the progress of the above issue closely and will continue to ascertain its relevancy to the ICM, especially should IOSCO undertake any new work on a capital standard.

2.2 RECENT INITIATIVES UNDERTAKEN BY THE IFSB

2.2.1 New Standards

2.2.1.1 Technical Note on Stress Testing for IIFS

As discussed in the IFSI Stability Report 2015, the IFSB is preparing a Technical Note on Stress Testing for IIFS. A Task Force for Stress Testing for IIFS (TFST) was established comprising 21 members from RSAs and international organisations. The TFST held four meetings, and the Technical Note (TN) will be ready for public consultation following approval by the IFSB Technical Committee in March 2016. The TN is planned for finalisation by the end of 2016.

Stress testing is one of the key risk management tools for financial institutions and is an important part of the supervisory assessment under Basel II's Pillar 2, especially post-GFC. This tool plays a particularly important role in the risk management of both conventional and Islamic banks, by: (i) providing forward-looking assessments of risk; (ii) estimating the impact of low-frequency, high-impact events; (iii) feeding into capital planning procedures, including the internal capital adequacy assessment process (ICAAP) and liquidity planning procedures; and (iv) facilitating the development of risk mitigation or contingency plans across a range of stressed conditions.

[84] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD473.pdf.

Stress testing for risk management is one of the most under-developed areas within the IFSI. Stress tests should be conducted on all material aspects and in relation to extreme but plausible scenarios, with special attention to the position and impact of the IAHs. The credit, market, operational and liquidity risk profiles of Islamic financial instruments do not correspond exactly to those of conventional financial instruments.

The TN is intended to offer detailed guidance on the operationalisation of IFSB-13: Guiding Principles on Stress Testing for IIFS, which provides guidance to IIFS and RSAs on assessing and capturing vulnerabilities under various stress-testing scenarios, and addressing the technical details of stress testing for IIFS.

The TN has been prepared with the following objectives (which are not intended to cover all aspects of stress testing):

- to facilitate the design and simulation of solvency and liquidity stress tests for IIFS, including providing guidance on establishing macrofinancial links, running scenarios of various assumptions and stress parameters;
- to highlight the specificities of risk exposures in IIFS and how they need to be captured in a stress-testing exercise; and
- to provide stylised numerical examples of IIFS stress tests under different shock scenarios.

The TN covers the banking sector and is aimed at both institutional-level (i.e. used by institutions to assess their risk tolerance and capital level) and industry-wide stress tests (i.e. used by RSAs as a supervisory tool for financial stability analysis stress testing).

The TN addresses multiple types of risk and their interrelated effects on overall financial position and performance of the portfolio, institution, group or system. These risks include credit risk within financing portfolios, equity risk in equity investment portfolios, market risk in relation to assets held, foreign exchange risk, rate of return risk, liquidity risk and operational risk (including Sharī'ah non-compliance risk). The TN provides satellite models that are designed to capture solvency stress impact on single-risk factors (credit risk and market risk) from three macroeconomic shock events. The impact of these shocks on the respective credit and market risk portfolios is then transformed as an impact on regulatory capital ratios. The TN acknowledges the risks borne by profit-sharing investment accounts (PSIA) in which the proportion of RWAs that needs to be included in the capital adequacy ratio (CAR) to cater for the transfer of risk from IAHs to IIFS is denoted by "alpha". The provided templates allow these assessments to be reflected in the computation of capital adequacy in the stress scenarios. The main challenge facing IIFS and their supervisors, however, is to correctly decide and assess the risk-sharing level between IIFS' own capital (shareholders' funds) and that of the IAH. The TN also shows how to design scenario analyses rather than single factor shocks, because in the macroeconomic context changes in several risk factors are typically interrelated.

From the liquidity risk perspective, the TN provides a liquidity stress test template that simulates IIFS-run-type scenarios for 5 and 30 days, while accounting for fire sales of liquid assets, maturity mismatch analysis, and Basel III liquidity ratios (LCR and NSFR). The template takes into account the characteristics of the main income-generating accounts of Islamic banks (unrestricted (UPSIA) and restricted profit-sharing investment accounts (RPSIA)). In principle, the profit- and loss-sharing nature of IIFS has reduced liquidity risk problems, since if the IAH does not have the right to make withdrawals at short notice, liquidity stress events affecting PSIA concern the IAHs and not the IIFS itself. However, because of the common practice in the market, UPSIA commonly have withdrawal rights at short notice before maturity, which leads to unexpected cash outflows in the stress times as with conventional banks. For RPSIA, IAH may have no withdrawal rights prior to maturity, or IAH may have withdrawal rights subject to giving early notice; hence the IIFS managing the RPSIA is not exposed to immediate liquidity withdrawal.

2.2.1.2 Guiding Principles for *Retakāful* (Islamic Reinsurance)

The work on Guiding Principles for *retakāful* (Islamic Reinsurance) started after the Council approved the preparation of a new standard on *retakāful* in December 2013. A working group was formed comprising members of the IFSB from RSAs and multilateral organisations, as well as industry players. It aims to address issues pertaining to the *retakāful* sector.

During the course of development of the standard, a survey was undertaken. Feedback on the current practices of *retakāful* was gathered from RSAs and *retakāful* operators (RTOs), as well as *takāful* operators (TOs). From the total number of 67 respondents, 14 were RTOs, 38 were TOs and 15 were RSAs. This section intends to provide an overview of the current practices of the industry and of regulation of *retakāful* practices. The survey summarised here has subsequently set the tone for the drafting of the Guiding Principles for *Retakāful* (Islamic Reinsurance) document.

Based on the survey responses from RTOs and TOs, the *retakāful* sector appears heavily dependent on proportional treaty for revenue, with some venturing into facultative, non-proportional treaty and other forms of arrangement.

Not all RTO companies have a single operating model. Indeed, in a small number of cases, different *retakāful* Risk Funds (RRFs), sub-funds, cells, etc. may be set up according to different contractual arrangements.

A significant minority of RTOs indicated that their remuneration includes a share of underwriting surplus, and a significant minority also indicated that they did not share investment income. The normal Sharīʿah understanding is that a surplus achieved under a *wakālah* contract cannot be shared with the *wakīl* (though a performance fee may be permissible). On the other hand, profit under a *muḍārabah* contract is shared between the parties in an agreed ratio. [85]

On the payment of profit and ceding commission, the general practice appears to be that commission is payable to the Participant's Risk Fund and not the shareholders' fund. However, instances of the latter are reported. It should also be noted that some of the payments made as commission have little to do with the normal understanding of that word,[86] and may be quoted as commission for accounting or tax purposes. RSA respondents provided limited comment on the question of the fund to which commissions are payable, with few appearing to prescribe, or even be aware of, the fund to which TOs credit this item.

On observance of Sharīʿah compliance, there is a general consensus among operators on the need for Sharīʿah approval to cover a broad spectrum of activities, but many respondents, both TOs and RTOs, indicated that they did not provide Sharīʿah advisers with technical training in *retakāful*/reinsurance. Where business is accepted by RTOs from conventional insurers, there is recognition that Sharīʿah approval is required. However, there is extensive reliance on cedant Sharīʿah governance when accepting business from TOs. On the continuing reliance on conventional reinsurance companies, the given reasons for the use of conventional reinsurance and retrocession are practical: insufficiency of expertise, financial strength, capacity and diversification.

Table 2.2.1.2.1 Breakdown of Islamic Finance Segments by Region (USD billion, 2015 YTD*)

Reasons	Yes	No	No Response
Perceived poorer service of the RTOs compared to conventional reinsurers	–	5	9
More favourable terms and conditions from conventional reinsurers	–	5	9
Lack of relevant expertise in the *Retakāful* market	7	3	4
Inadequate financial strength in the *Retakāful* market	5	3	6
Inadequate capacity in the *Retakāful* market	10	1	3
Inadequate diversity in the *Retakāful* market	6	2	6
Lower security (or lower ratings) of *Retakāful* Operators	3	3	8
Demanded by cedant TOs as part of *Takāful* programme	–	6	8
We do not place retrocession arrangements with conventional reinsurers	–	5	9
Other	3	1	10

From a corporate governance perspective, the majority of the RTOs state that they have to comply with similar regulatory requirements to conventional reinsurers, but subject to modification to reflect Sharīʿah compliance. (RSA responses broadly support this picture.) The survey responses suggest greater use of risk sharing than feared, but responses indicate that some segregation by the cedant clearly does occur (whether within a formal cell structure or not). At least one RTO respondent indicated that some parts of its business were pooled and some were not. (In some instances, the absence of pooling may reflect captive arrangements that effectively provide the originator of the risk with a structured form of risk retention.) Roughly half the TOs responding were uncertain if the risks of RTOs are pooled or not pooled. This indicates the possibility of lack of transparency in the treaty between TOs and RTOs.

Generally, RSAs do not appear to address capital requirements for individual funds, or the issue of deficits. In addition to this, a significant minority of RSA respondents state that reinsurance/*retakāful* is not regulated in the jurisdiction. Operators take a variety of approaches to deficiency, with outright donation to the RRF reported only by windows. Most respondents reported either *qarḍ* or earmarking of assets. It is clear that many expect *qarḍ* or the earmarking of assets to be in place for substantial periods, which creates issues both of accounting and of the treatment of the relevant assets in an insolvency. Regulatory intervention in the *retakāful*/

[85] The *wakālah–muḍārabah* model proved to be the more popular. In this model, as commonly practised, the RTO acts both as a *wakīl* and a *muḍārib* (entrepreneur) to the *Takāful* Undertakings: typically, as *wakīl* to manage the underwriting activities of the RRF, and as *muḍārib* to manage its investment activities.

[86] It is common for cedants on proportional *retakāful* and reinsurance contracts to receive a percentage discount on the contribution or premium paid, expressed as a ceding commission. Historically, ceding commissions have been regarded as compensation for the cedant for its acquisition and overhead costs.

reinsurance programme of TOs is limited, with a majority of respondents indicating that granular requirements were not present. The most prevalent related to financial strength – that is, ratings.

The detailed report of the survey summarised above was an important input to the drafting of IFSB-18: Guiding Principles for *Retakāful* (Islamic Reinsurance). The final document aims to provide a basis for RSAs to set rules and guidance on the operational framework of entities undertaking inward *retakāful* activities. It also outlines a basis for regulators to supervise *takāful* and *retakāful* undertakings' use of outward *retakāful* arrangements and, finally, suggests recommended best practices for RTOs and TOs and their regulators to help address regulatory issues concerning *retakāful*. The five main principles cover: (a) governance of *retakāful* undertakings; (b) compliance with Sharī'ah principles; (c) prudential framework; (d) transparency and disclosure; and (e) supervisory review of *retakāful* /reinsurance arrangements.

2.2.1.3 Guiding Principles on Disclosure Requirements for Islamic Capital Market Products

In September 2012, the IFSB, with IOSCO and the Securities Commission Malaysia, held a Roundtable on Disclosure Requirements for Islamic Capital Market Products. The Roundtable identified a number of respects in which ICM products raised disclosure issues different from, or supplementary to, those of their conventional counterparts. This, in turn, led the Council of the IFSB to agree to start preparing a standard focusing on disclosure requirements for ICM products.

The Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (the "Standard") are intended to meet the following objectives:
(a) to provide a basis for RSAs to set rules and guidance on disclosure requirements for some ICM products, such as *sukūk* and ICIS;
(b) to outline a basis for RSAs to assess the adequacy of the disclosure frameworks specified by the relevant bodies (e.g. by an exchange which is also a listing authority); and
(c) to provide a comprehensive disclosure framework for participants in the ICM (e.g. investors, issuers, investment managers, etc.).

As part of the formulation of the Standard, a survey for capital market regulators, exchanges and market players was conducted in the third quarter of 2015. The key purposes of the survey were to: (i) ascertain key aspects of the existing regulatory framework (including policies and procedures) developed by the supervisory authorities to ensure adequate disclosure and transparency; (ii) identify further practices and regulations that might enhance disclosure and transparency of the above ICM products; and (iii) recognise existing practices and regulations with regards to disclosure of ICM products, particularly *sukūk* and ICIS.

Survey Findings

The survey was divided into four sections – namely, general information, disclosure requirements for *sukūk*, disclosure requirements for ICIS, and other issues. It was found that although, in general, jurisdictions had available a range of capital markets instruments, some did not as yet have *sukūk* or ICIS. At the same time, while most jurisdictions have additional or special capital market regulation/policy/guidelines to regulate ICM products, some indicated that they regulate ICM products no differently to conventional products. Nevertheless, some of these jurisdictions apply general provisions and regulatory discretion within their regulatory regimes to require some special disclosures for ICM products.

In terms of disclosure requirements for *sukūk*, the survey revealed varied approaches to the definition of public and private offerings and that almost all jurisdictions require a prospectus for a public offering. The majority of respondents also indicated that governments and multilateral agencies are generally exempted from the normal disclosures and that the issuer/Special Purpose Vehicle (SPV) is treated as primarily responsible for all disclosures. According to the majority of RSAs, *sukūk* are typically recognised as a separate security (as opposed to them being classified as debt securities). However, responses from the market participants suggest that treatment of *sukūk* as debt securities may be more common in non-member jurisdictions. On the subject of special types of *sukūk*, most jurisdictions confirmed that they have no specific disclosure requirements in place. They have also not suggested that there be future standards for special *sukūk*, and this is broadly agreed by market participants. Nonetheless, there were some suggestions to include disclosures broadly paralleling conventional bonds for convertible *sukūk* and some specific disclosures for regulatory capital *sukūk*. In comparing disclosures required in prospectuses for both public offering and private offering of both government and corporate *sukūk*, regulators' results showed that disclosures about Sharī'ah scholars and reasoning are less commonly required than one might have expected. In contrast, market participants' views reveal that as a matter of market practice, information about scholars and their reasoning is disclosed more frequently than is required by regulation. The respondents also confirmed their preference that the proposed Standard should be supplementary to existing standards.

Under the disclosure requirements for ICIS, the survey showed that the open-ended investment company structure is the predominant legal form for CIS, but that other structures were also being utilised, such as unit trusts and close-ended companies. Consequently, it was found that ICIS generally use the same structures as conventional ones, and no new structures were identified. Most jurisdictions claimed that they have implemented the principal IOSCO standards relevant to CIS, but lower results were recorded on the implementation of IFSB standards. However, a jurisdiction which has fully implemented the IOSCO standards for its ICIS will have implemented all aspects of the relevant IFSB standards, except for Sharīʾah-related disclosures.

Most RSAs responded that they have special requirements and disclosures for ICIS. The most common disclosures include a basic requirement for the ICIS to be operated in a Sharīʾah-compliant manner, details of the Sharīʾah adviser and the relevant Fatwa. This is followed by other disclosures, with most of those required by regulation or sought by respondents pertaining to Sharīʾah governance and decisions, *zakāh* and purification of tainted income. The survey also indicated that regulators wanted the Standard to cover money market funds, Islamic real estate investment trusts (REITs) and Islamic exchange-traded funds (ETFs).

As for other issues, a large majority of the regulators did not identify any ICM products in their country that pose disclosure issues that are different from those facing their conventional counterparts. Most market participants, on the other hand, did not provide any answers on this issue, but those who did mentioned derivatives, structured products and convertibles.

Exposure Draft

Prior to the release of the Standard in 2017, an Exposure Draft (ED) is expected to be issued for public consultation by the end of 2016. It is envisioned that the ED will include general principles which are applicable to disclosure requirements for *sukūk* and ICIS, such as information that is clear, truthful, sufficient and timely. The Standard is also expected to cover the main stages of disclosure – that is, initial, ongoing (periodic and immediate) and point-of-sale disclosure – in so far as they are applicable to *sukūk* and ICIS.

In discussing disclosures for *sukūk*, the Standard is anticipated to explore its application to private offerings, government and multilateral issuances, and cross-border issuances. Other aspects to be addressed are Sharīʾah-related disclosures and structure-related disclosures, along with the parties liable for such disclosures.

With regard to disclosures required for ICIS, the Standard is planned to discuss applications to different legal structures as well as cross-border sales. Similar to *sukūk* disclosures, there will also be discussions on Sharīʾah-related disclosures and structure-related disclosures for ICIS. In addition, the Standard is expected to examine disclosures for specialist ICIS, such as Islamic REITs, Islamic ETFs and MMFs, among others.

The Standard is intended to deal only with those areas in which ICM products require disclosures additional to, or different from, those required of their conventional counterparts. It will not attempt to duplicate the conventional standards by specifying all relevant disclosures, including those which are common to conventional and Islamic products.

2.2.2 The IFSB Surveys

2.2.2.1 Survey on Standards Implementation, 2015

IFSB members implement the IFSB's standards and guidelines on a voluntary basis. Each member of the IFSB is entitled to determine its own timeline for implementation based on the market and industry dynamics in its territory/jurisdiction. In its Strategic Performance Plan 2016–2018, the IFSB identifies four strategic key result areas (SKRAs), which include SKRA 2: Facilitating the Implementation of Prudential Standards and Capacity Development. The formulation of a detailed and effective work programme under this SKRA requires the IFSB Secretariat to conduct an annual implementation survey to capture not just the breadth of implementation (e.g. the number of countries implementing), but also closely linked issues such as challenges being faced by the member RSAs in the implementation of standards and the support they expect from the IFSB Secretariat. Following this, in 2015 the IFSB undertook its fourth IFSB Standards Implementation Survey ("2015 Survey") to assess the implementation status of the IFSB standards, with a view to formulating its strategy to support the implementation process over the medium to longer term.

[87] Refer to www.ifsb.org/published.php for a full list of IFSB standards.

Diagram 2.2.2.1.1 The IFSB's Strategic Performance Plan 2016–2018

SKRA 1	SKRA 2	SKRA 3	SKRA 4
Formulation and Issuance of Prudential Standards and Studies for the Regulation of the IFSI	Facilitating the Implementation of Prudential Standards and Capacity Development	Increasing Awareness and Knowledge Sharing	Enhancing Cooperation with the Islamic Finance Stakeholders
• Enhanced guidance on the prudential supervision of IFSI • Expansion of coverage of IFSI issue areas	• Increased implementation of the IFSB standards in member jurisdictions • Enhanced capacity of member jurisdictions to understand the enabling factors for an effective regulatory and supervisory system	• Improved awareness of stakeholders on the growth and soundness of the IFSI • Enhanced knowledge sharing through the dissemination of information	• Improved cooperation with members and non-members of the IFSB • Increased satisfaction of members with the services provided by the IFSB

Source: IFSB Strategic Performance Plan 2016–2018.

In the 2015 Survey, 39 RSAs from 27 countries responded to the survey, representing various regions including Asia, Africa, the Middle East and Europe. This response rate was materially higher than in 2014, when 27 RSAs responded (not all of which responded in 2015). Since the new respondents are on average less advanced in standards implementation, comparisons between the two years need to be drawn with great caution.

The survey inquired about the implementation status of 17 IFSB standards and Guidance Notes as of December 2015 that covered the three sectors of the IFSI – namely, Islamic banking, *takāful* and the Islamic capital market, including the cross-sector standards on conduct of business and Sharīʻah governance (see Diagram 2.2.2.1.2). IFSB-17 (Core Principles for Islamic Finance Regulation for the Banking Segment), issued in April 2015, was not included in this survey.

Of the standards considered, three (IFSB-2, IFSB-5 and IFSB-7) have been superseded (by IFSB-15 and IFSB-16). This will affect the extent to which jurisdictions now plan to implement these older standards.

Diagram 2.2.2.1.2 List of IFSB Standards for 2015 Survey

11 Standards

BANKING SECTOR

- IFSB-1 Guiding Principles of Risk Management for IIFS (2005)
- IFSB-2 Capital Adequacy Standard for IIFS (2005)
- IFSB-3 Guiding Principles on Corporate Governance for IIFS (2006)
- IFSB-4 Disclosures to Promote Transparency and Market Discipline for IIFS (2007)
- IFSB-5 Guidance on Key Elements in the Supervisory Review Process of IIFS (2007)
- IFSB-7 Capital Adequacy Requirements for *Sukūk*, Securitisations and Real Estate Investment (2009)
- IFSB-12 Guiding Principles on Liquidity Risk Management for IIFS (2012)
- IFSB-13 Guiding Principles on Stress Testing for IIFS (2012)
- IFSB-15 Revised Capital Adequacy Standard for IIFS (2013)
- IFSB-16 Revised Guidance on Key Elements In The Supervisory Review Process of IIFS (2014)
- GN-6 Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS (2015)

1 Standard

ISLAMIC CAPITAL MARKET SECTOR

- IFSB-6 Guiding Principles on Governance for Islamic Collective Investment Schemes (2008)

3 Standards

TAKAFUL SECTOR

- IFSB-8 Guiding Principles on Governance for *Takāful* Undertakings (2009)
- IFSB-11 Standard on Solvency Requirements for *Takāful* Undertakings (2010)
- IFSB-14 Standard on Risk Management for *Takāful* Undertakings (2013)

2 Standards

CROSS SECTOR

- IFSB-9 Guiding Principles on Conduct of Business for IIFS (2009)
- IFSB-10 Guiding Principles on Sharīʻah Governance Systems for IIFS (2009)

** IFSB -17 was not covered this year*

The key findings of the 2015 Survey are presented below.

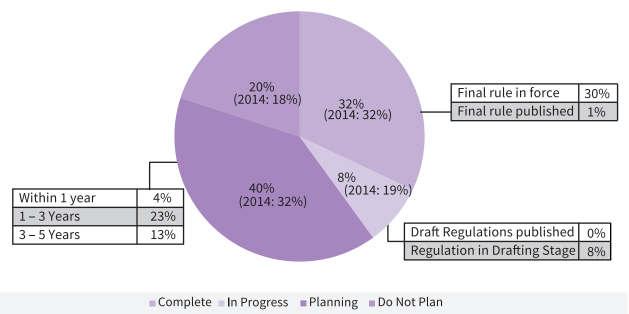
Implementation Status Progress

The number of standards completed is still similar to 2014, with only one-third considered as "Complete". "Do Not Plan [to Implement]" is also consistent with previous years of assessment at only 20%. The main year-on-year differences are with the "In Progress" and "Planning" stages, where "In Progress" has decreased (from 19% to 8%), while "Planning" has experienced a slight increase (from 32% to 40%) (see Chart 2.2.2.1.1). The difference in "In Progress" is due to the decline in IFSB-2, IFSB-5 and IFSB-7, which have been replaced by IFSB-15 and IFSB-16; while the difference for the "Planning" stage may be due to the different base of RSA members being included in the assessment this year. RSAs in the Africa region tend to have fewer standards "In Progress", while RSAs in the Middle East region have fewer being planned.

With the exception of Islamic banking, all sectors have seen a consistent performance trend since 2014. Within Islamic banking, there has been a drop in implementation for IFSB-2, IFSB-5 and IFSB-7. This is most likely attributable to these standards being replaced by IFSB standards 15 and 16. Total implementation stands at 32%. The breakdown of implementation by standard and by sector is shown in Chart 2.2.2.1.1.

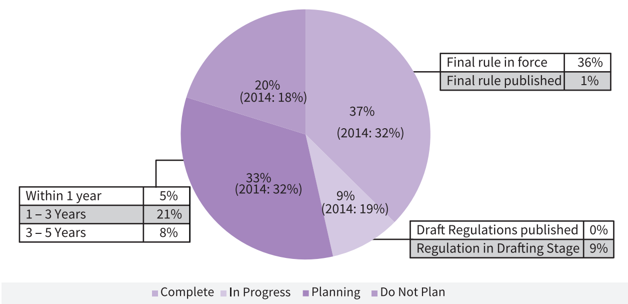
Excluding those members who did not participate last year, the "Complete" status is higher by 5% and "Planning" status is down by 7%. This is visible in Chart 2.2.2.1.2.

Chart 2.2.2.1.1
RSA Overall Implementation Status



Base: All respondents, n=39.
Source: IFSB Standards Implementation Survey, 2015.

Chart 2.2.2.1.2
Consistent RSA Members – Overall Implementation Status



Base: All respondents, n=22.
Source: IFSB Standards Implementation Survey, 2015.

Moving on to the second dimension of standards implementation, 'In Progress', within Islamic banking, major declines are from IFSB-12 and IFSB-16. The decline in IFSB-16 is again possibly due to IFSB-5 having been replaced, resulting in less compliance. On the other hand, IFSB-12 saw an increase in completion rates (from 11% to 41%). We also see drops in *takāful*, but there were also slight increases in completion for all three standards. Other sectors showed consistent trends. Total implementation rated as "In Progress" stands at 8%, and the details by sector and by standard are shown in Chart 2.2.2.1.4.

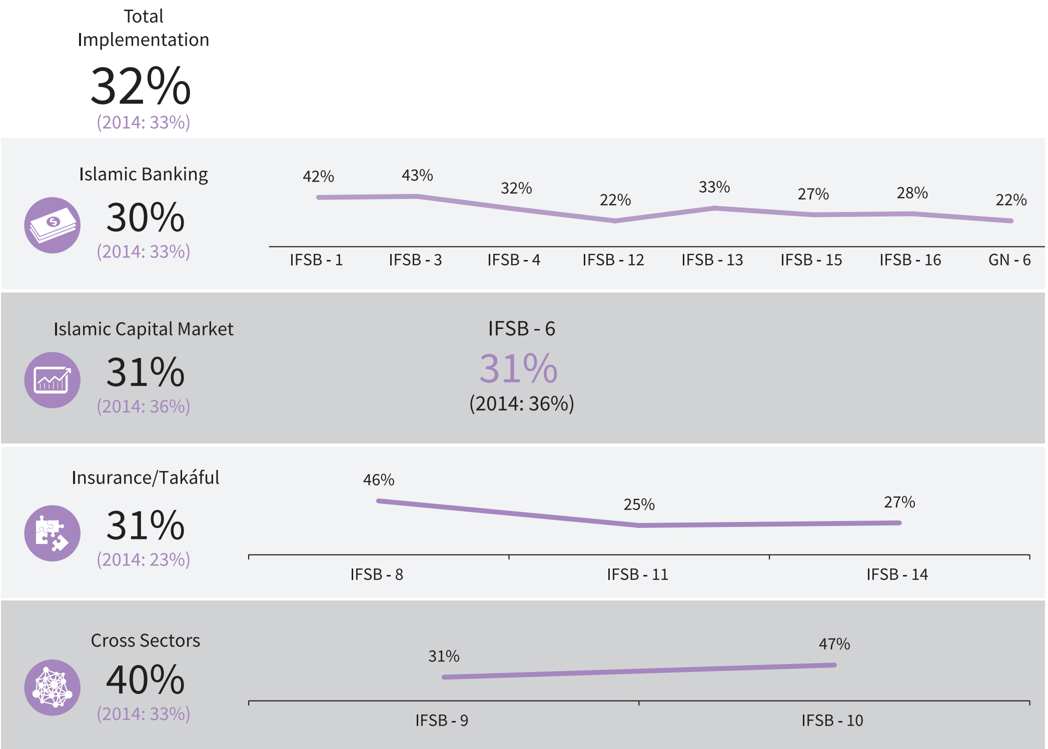
Overall Assessment

Chart 2.2.2.1.5 provides an analysis of standards implementation by the RSAs and the market share for Islamic finance in the relevant sector. Although some sample sizes are small, the analysis does suggest that standards implementation rates have some correlation with the market share of the Islamic finance sectors, especially in Islamic banking and *takāful*.

Unsurprisingly, the adoption of standards is seen to have an inverse correlation with the date of introduction. Thus, newly introduced standards show less implementation progress. However, when comparing implementation progress as a function of time, it is observed that the implementation speed is increasing.

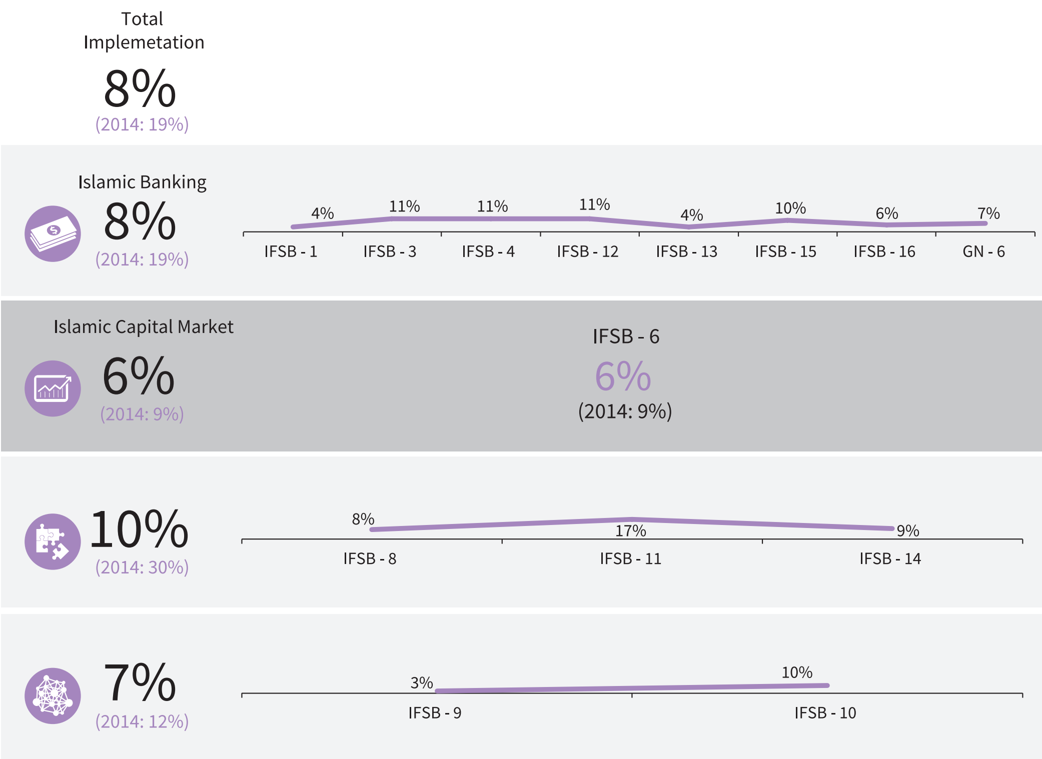
The data for IFSB-2, IFSB-5 and IFSB-7 are affected by the fact that these standards have been superseded. However, the following figure shows that there has been a quick take-up of the recently issued standards such as IFSB-13, IFSB-14 and IFSB-15, where average rate of RSAs implementing a standard per year has been quite high (more than 6.5 implementations per year).

Chart 2.2.2.1.3
RSA Members and Implementation by "Complete" Status



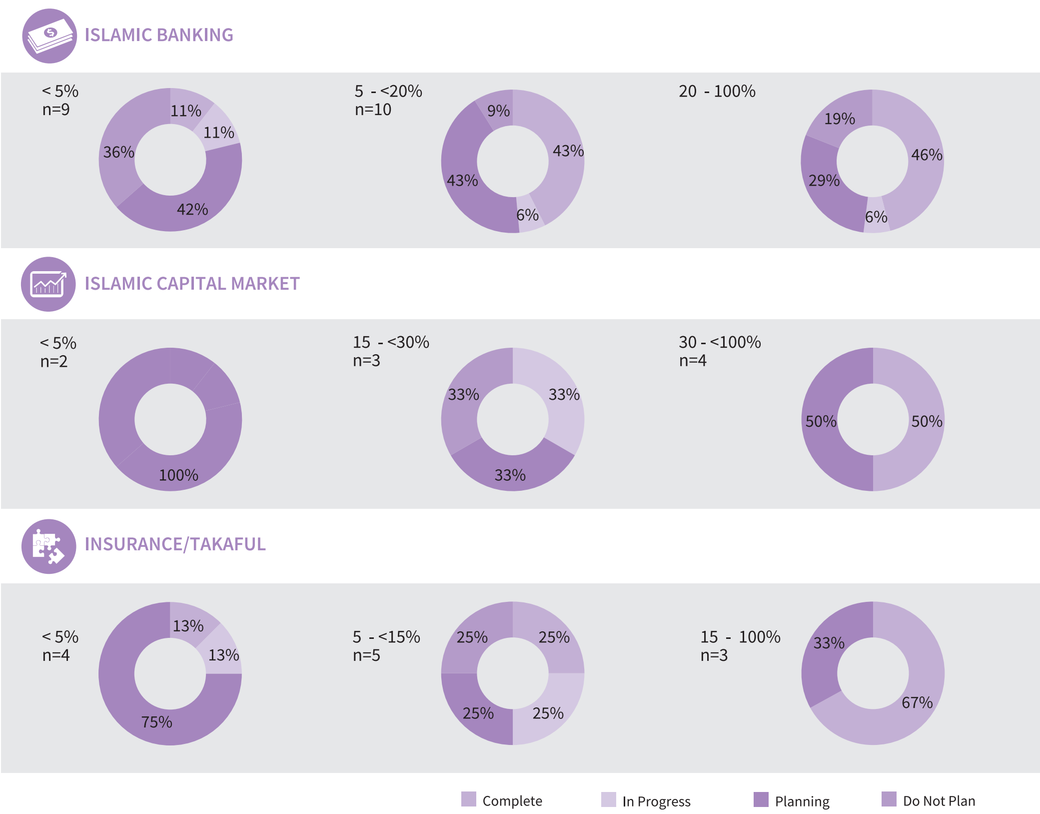
Base: All respondents, n=27.
Source: IFSB Standards Implementation Survey, 2015

Chart 2.2.2.1.4
RSA Members and Implementation Progress by "In Progress"



Base: All IFSB respondents, n=39.
Source: IFSB Standards Implementation Survey, 2015.

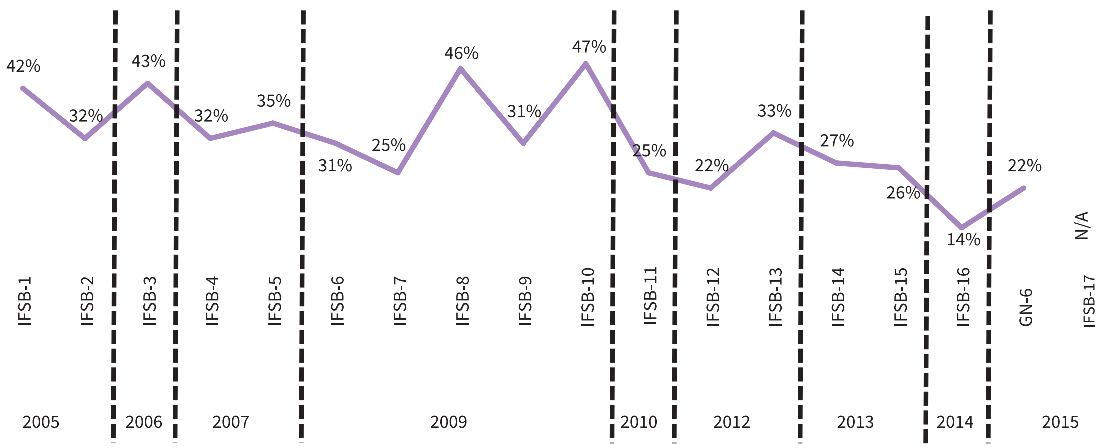
Chart 2.2.2.1.5
RSA Members and Market Share vs Implementation Analysis



Base: Respondents, n=27.
Source: IFSB Standards Implementation Survey, 2015.

Chart 2.2.2.1.6 shows details of the various average rates of implementation, based on the shared years of introduction for each standard. The years are counted as a full 12 months for each standard.

Chart 2.2.2.1.6
Standards Completed by Timeline



Average rate of RSA implementation per 1 year

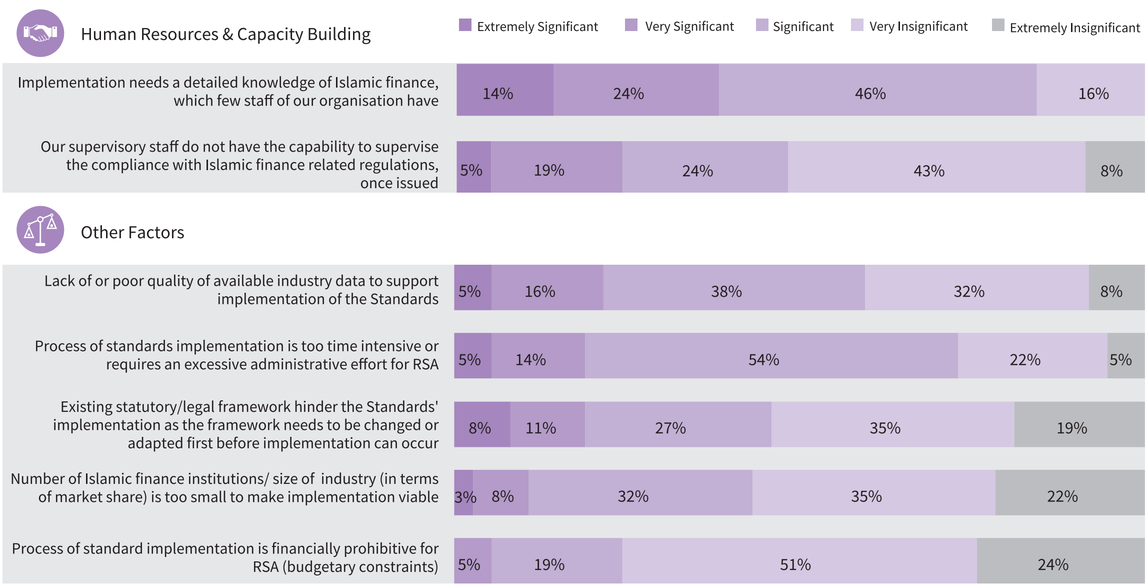
4.2	3.2	4.7	4.0	4.3	4.4	3.5	6.5	4.4	6.7	4.1	4.4	6.6	6.8	6.5	4.6	22	-

Base: All respondents, n=39.
Source: IFSB Standards Implementation Survey, 2015.

Challenges in Implementation

RSAs were asked how significant they considered each of several possible challenges in implementation. “Detailed knowledge of Islamic finance” appears to be a challenge most RSAs perceive as significant, while “Standard implementation is financially prohibitive” is the least challenging factor in implementation. “Lack or poor quality of industry data” and “Excessive administrative efforts for RSAs” are also considered major challenges.

Chart 2.2.2.1.7
Challenges in Implementation



*Base: All respondents, n=37. (*Two RSA members did not answer.)*
Source: IFSB Standards Implementation Survey, 2015.

European RSAs appear to find most of the challenges significant (but in a very small sample), while Asian RSAs have fewer challenges on average. Middle Eastern and African RSAs do not find most of the challenges very significant.

Chart 2.2.2.1.8
Challenges in Implementation by Region
(proportion scoring a challenge as Extremely Significant or Very Significant)

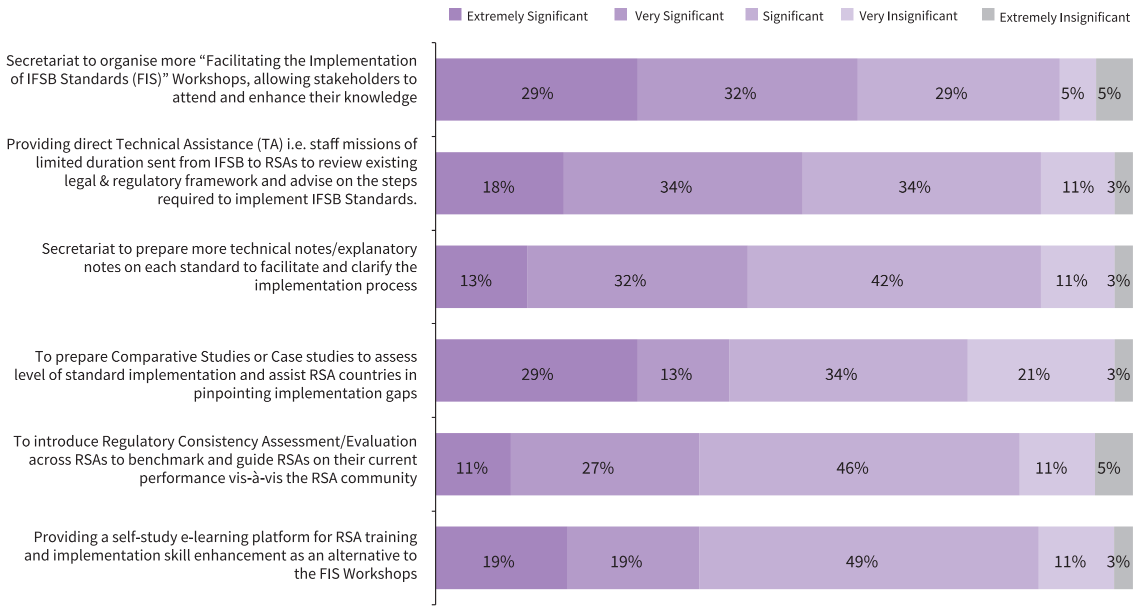
Challenges	Total (N=27)	Africa (n=9)	Asia (n=10)	Europe (n=4)	Middle East (n=14)
Human Resources & Capacity Building					
Implementation needs a detailed knowledge of Islamic finance, which few staff of our organisation have	38%	11%	30%	25%	0%
Our supervisory staff do not have the capability to supervise the compliance with Islamic finance related regulations, once issued	24%	33%	20%	75%	7%
Other Factors					
Lack of or poor quality of available industry data to support implementation of the Standards	22%	22%	30%	25%	14%
Process of standards implementation is too time intensive or requires an excessive administrative effort for RSA	19%	11%	20%	50%	14%
Existing statutory/legal framework hinder the Standards’ implementation as the framework needs to be changed or adapted first before implementation can occur.	19%	11%	20%	75%	7%
Number of Islamic finance institutions/ size of industry (in terms of market share) is too small to make implementation viable	11%	11%	10%	50%	0%
Process of standard implementation is financially prohibitive for RSA (budgetary constraints)	5%	0%	10%	25%	0%

*Base: All IFSB respondents, n=37. (*Two RSA members did not answer.)*
Source: IFSB Standards Implementation Survey, 2015.

Type of Support Desired by RSA

RSA members were asked to indicate those areas where they wish to receive support from the IFSB Secretariat. They were encouraged to rate the areas from "Extremely Significant" to "Extremely Insignificant" in terms of need for support. A majority of the proposed activities are rated as at least "Significant", with the highest scores going to workshops to facilitate the implementation of standards (FIS) and providing direct technical assistance (TA) (Chart 2.2.2.1.9). Chart 2.2.2.1.9 shows the breakdown of the most significant support desired by regional cluster.

Chart 2.2.2.1.9
Support in Implementing Standards



*Base: All respondents, n=38. (*One RSA member did not answer.)*
Source: IFSB Standards Implementation Survey, 2015.

Despite (in general) scoring the challenges less highly than other regions, African RSAs appear to require a higher level of support. This may reflect the fact that in many of the African countries the development of Islamic finance is at an early stage.

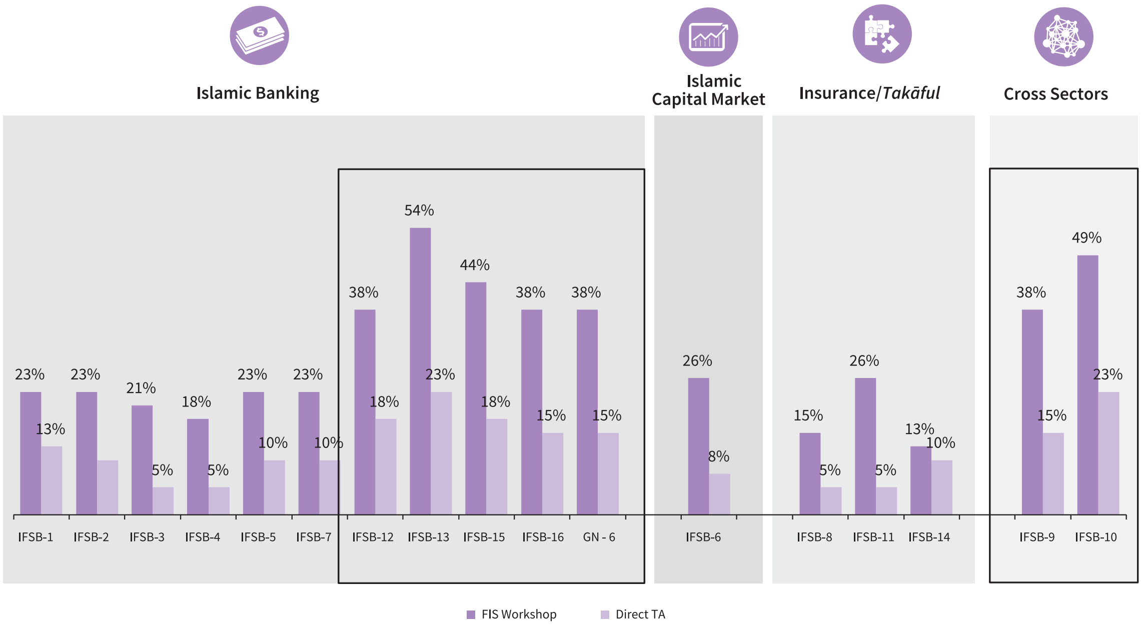
Chart 2.2.2.1.10
Support in Implementing Standards – Regional Cluster
(top 2 box with "Extremely Significant" and "Very Significant")

Challenges	Total (N=38)	Africa (n=9)	Asia (n=10)	Europe (n=4)	Middle East (n=15)
Secretariat to organise more "Facilitating the Implementation of IFSB Standards (FIS)" Workshops, allowing stakeholders to attend and enhance their knowledge	61%	67%	80%	50%	47%
Secretariat to prepare more technical notes/explanatory notes on each standard to facilitate and clarify the implementation process	53%	78%	30%	75%	47%
To prepare Comparative Studies or Case studies to assess level of standard implementation and assist RSA countries in pinpointing implementation gaps	45%	67%	40%	25%	40%
Providing direct Technical Assistance (TA) i.e. staff missions of limited duration sent from IFSB to RSAs to review existing legal & regulatory framework and advise on the steps required to implement IFSB Standards.	42%	78%	30%	50%	27%
To introduce Regulatory Consistency Assessment/Evaluation across RSAs to benchmark and guide RSAs on their current performance vis-à-vis the RSA community	38%	56%	10%	50%	43%
Providing a self-study e-learning platform for RSA training and implementation skill enhancement as an alternative to the FIS Workshops	38%	22%	30%	50%	50%

*Base: All respondents, n=38. (*One RSA member did not answer.)*
Source: IFSB Standards Implementation Survey, 2015.

Members were also asked on a standard-by-standard basis about the desirability of FIS workshops or direct TA for all the standards (Chart 2.2.2.1.11).

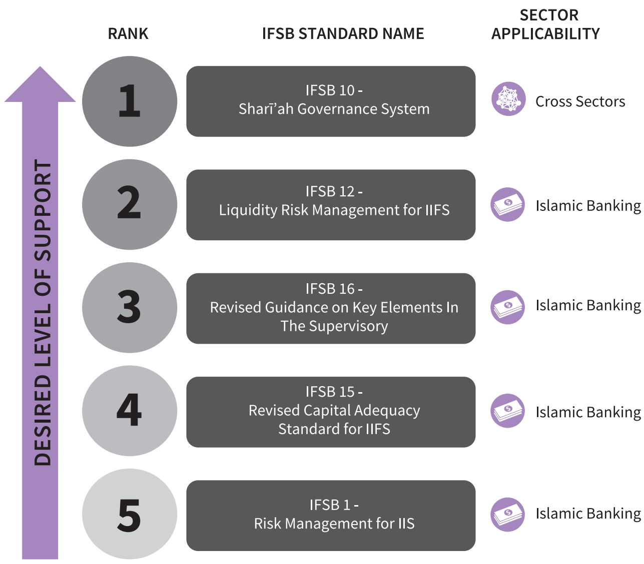
Chart 2.2.2.1.11
FIS Workshop and Direct TA



Base: All respondents, n=39.
Source: IFSB Standards Implementation Survey, 2015.

Chart 2.2.2.1.12 shows that IFSB-10, on Sharīʻah governance, has been rated as the top-most priority for obtaining support (FIS workshop and direct TA) at an overall level. This standard is applicable across sectors, making it very important for future support activities. A group of standards applicable to Islamic banking make up the next four ranks with standards IFSB-12, IFSB-16, IFSB-15 and IFSB-1.

Chart 2.2.2.1.12
Standards Priority for Workshop and Direct TA
(ranks 1 to 5)



*Base: All IFSB respondents, n=21. (*Eighteen RSA members did not rank their priorities.)*
Source: IFSB Standards Implementation Survey, 2015.

Key Conclusions

- There has been a quick take-up of the recently issued standards, such as IFSB-13, IFSB-14 and IFSB-15, where average number of RSAs implementing a standard per year has been quite high (more than 6.5 implementations per year).
- However, members are still adjusting to these and other recent standards in the banking sector and are desirous of more support in implementing the standards. The transition time provided in the latest Basel III-related standards (IFSB-15, IFSB-16 and GN-6) makes possible gradual implementation of the standards.
- Examining implementation across the years with a consistent set of RSAs, it can be seen that implementation has remained consistent or has grown. However, the higher response rate this year has made it possible to see that there are still many RSAs at an early stage of standards implementation.
- Basel III RSAs are seen to have higher compliance rates, possibly due to their being more "advanced" from a regulatory or economic perspective. At the same time, these RSAs still have issues with completing the implementation of newer standards.
- There are good indications that standard implementation rates have some correlation with the market share of the Islamic finance sectors, especially in Islamic banking and *takāful*.
- There are many RSAs who do not consider that they have staff with the necessary depth of knowledge in Islamic finance to implement the standards. This may be one of the reasons why IFSB-10 is another standard that scores high on need for support.
- African RSAs require more support for implementation.
- FIS workshops and TA support are consistently rated as the most desired support mechanisms by the RSAs to enhance their staff or local stakeholders' awareness and skill sets. Members also prefer FIS workshops over direct TA when it comes to support. These findings will be reflected in the enhanced implementation activities that the IFSB will be putting in place over the SPP 2016–2018 period.

2.2.3 Other Initiatives of the IFSB

2.2.3.1 IFSB–IAIS Issues in Regulation and Supervision of *Microtakāful*

In continuing its effort to expand the coverage of new topics in Islamic finance, the IFSB, together with its conventional counterpart, the IAIS, jointly agreed to initiate work on financial inclusion, focusing on *microtakāful*. This is in line with the efforts of both institutions to extend and widen the access of financial services to the underserved segments of society through the study of underlying products and best practices in the field. The two standard setters established a joint working group to identify issues pertaining to the regulation and practices of *microtakāful*. This initiative aspired to widen the scope of understanding of the relevant regulatory issues for the improvement of the *microtakāful* sector. The study, which took a year and a half to complete, included a survey responded to by both IFSB and IAIS members from various jurisdictions. The survey questionnaire was sent to 64 institutions/RSAs, with the questionnaire also being made accessible to various *microtakāful* providers in the jurisdiction of these institutions/RSAs. Only 25 respondents provided feedback. The low response provided the first indication of the non-offering of *microtakāful* products in many of these jurisdictions. Throughout the research process, analysis of the existing literature on *microtakāful* also confirmed the lack of data and information on the practices and regulation of *microtakāful.*

Despite the lack of data availability, the survey process and study of progress in various jurisdictions revealed the existence of concerted efforts by various institutions in some jurisdictions to provide *microtakāful* coverage to the underserved. Three noticeable jurisdictions in which national efforts have been made are Indonesia, Pakistan and Sri Lanka. The collaboration between social and non-profit organisations and *takāful* operators in these countries has proven to be a key contributor to the expansion of *microtakāful* in these jurisdictions. Deregulation, as observed in Sri Lanka, has also been proven to encourage the entrance of new *microtakāful* providers into the industry.

Given the nature of microtakāful, being a sector that has yet to be given widespread recognition by the regulators, the joint initiative aims to identify the current practices and models that are being used by *microtakāful* providers worldwide. With this identification, the joint initiative strives to understand any regulatory framework that has been set up in any jurisdiction for the purpose of sharing the experiences of regulating *microtakāful* with other RSAs that may have the intention to look into regulating this sector. This is in the hope of triggering preparation of guidelines by the RSAs to begin supervising this sector more prominently and proficiently.

The Issues Paper received approval from the Technical Committee of the IFSB and the Executive Committee of the IAIS on 2 November 2015 and 16 November 2015, respectively. It is now accessible and downloadable from the web links[88] of both standard-setting bodies.

[88] www.ifsb.org/preess_full.php?id=320&submit=more, and http://iaisweb.org/index.cfm?event=getPage&nodeId=25295

The joint paper indicates many areas requiring careful deliberation by RSAs in outlining specific regulations for the *microtakāful* sector. The features of *microtakāful* products, despite to a certain extent emulating those of normal *takāful* products, pose unique supervisory challenges to RSAs. Some of these challenges include: supervision of the operational framework, Sharī'ah compliance, distribution channels, product contribution, claims settlement and, most importantly, the protection of key stakeholders' interests – namely the *microtakāful* participants, who may have limited understanding of their own rights.

While the expansion of *microtakāful* coverage is key to ensuring that the underserved segments of society are given equal opportunities to access Islamic financing, there are some critical areas requiring supervision by the RSAs to ensure that the stability of the industry is not compromised during the process of expansion.

Some of the critical areas that require careful scrutiny and clear guidance in supervising *microtakāful* include the separation of funds between the shareholders' fund and the participants' risk fund, the solvency and capital adequacy framework, investment policies and Sharī'ah compliance requirements. RSAs need also to pay specific attention to the consumer protection issues, which, among other matters, include customer education and awareness through easily accessible information-sharing mechanisms and complaints management.

The IFSB–IAIS joint paper has identified two areas for possible future work on *microtakāful*:

(a) Identifying a successful cooperation mechanism between stakeholders (especially between the RSAs, government agencies, *takāful* operators, *retakāful* operators and the Sharī'ah Board), and understanding the roles and responsibilities of each of the stakeholders.
(b) Delineating the specific areas to be looked into by RSAs and relevant authorities when regulating the *microtakāful* providers. These significant areas include the providers' corporate governance strategy and structure, solvency requirements, underwriting requirements, licensing provisions, fund management framework, consumer protection, use of digital technology and regulatory reporting.

2.2.3.2 Sharī'ah-compliant Deposit Insurance Coverage as a Safety Net

(a) Deposit insurance in the post-crisis financial stability framework

The GFC of 2008–2009 and the following European sovereign debt crisis of 2010–2011 have reignited policymakers' interest in financial safety net arrangements – that is, deposit insurance frameworks to provide protection to depositors in the interest of preventing panic runs on banks and lender-of-last-resort (LOLR) liquidity facilities for these institutions during times of liquidity stress. The turmoil in financial markets demonstrated not only that financial crises in advanced countries were still possible, but, more importantly, that the degree of interconnectedness and globalisation in financial markets and banking systems elevated the risk of contagion. As a result, the demand for insurance against these shocks has grown, as is commonly the case whenever a crisis hits the financial sector.

The common policy response to mitigate the adversities of the GFC in most of the affected jurisdictions overwhelmingly included government provision of a financial safety net for banks and other financial institutions. In jurisdictions with existing arrangements, the design of many safety net elements, such as deposit insurance, was redrawn as a short-term emergency measure to extend coverage of existing guarantees while introducing new ones. While these measures did not address the root causes of the lack of confidence, they were nevertheless helpful in avoiding a further accelerated loss of confidence.

During the build-up of the crisis in April 2008, the Financial Stability Board released its Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, which stressed the need for authorities to agree on an international set of principles for effective deposit insurance systems, and asked national deposit insurance arrangements to be reviewed against these principles and for authorities to strengthen arrangements where necessary. In response, the Basel Committee on Banking Supervision and the International Association of Deposit Insurers jointly issued, in June 2009, Core Principles for Effective Deposit Insurance Systems ("Core Principles") for the benefit of countries considering the adoption or the reform of a deposit insurance system. This was followed up with a methodology for compliance assessment with these Core Principles in 2010. The Core Principles and methodology were revised in 2014.

In February 2012, the FSB released its Thematic Review on Deposit Insurance Systems – Peer Review Report, which identified that explicit limited deposit insurance has become the preferred choice among FSB member jurisdictions. In particular, 21 out of 24 FSB members had established an explicit deposit insurance scheme (DIS) with objectives specified in law or regulations and publicly disclosed. Of the remaining jurisdictions, China and South Africa confirmed their plans to introduce a DIS and were actively considering its design features. The report also provided four recommendations for implementation by the FSB itself or relevant member jurisdictions based on the findings of the peer review. They involve:

(a) the adoption of an explicit DIS for those jurisdictions that do not currently have one;

(b) revisions in the design of existing DIS to fully align them to the Core Principles;
(c) additional analysis and guidance by relevant international bodies (primarily IADI); and
(d) the follow-up of peer review recommendations.

As such, in the new global financial stability framework post-financial crisis, DIS are in widespread use by RSAs across jurisdictions. As of 31 October 2014, the IADI reports that 113 jurisdictions have instituted some form of explicit deposit insurance, and another 40 jurisdictions are studying or considering the implementation of an explicit DIS.

(b) Sharī'ah-compliant deposit insurance schemes

The role of financial safety nets is also critical in the global Islamic financial services industry as it evolves into a multi-trillion dollar industry. Chapter 1 of this stability report notes that the IFSI is estimated to be worth USD1.88 trillion in 2015 YTD.[89] Nearly 80% of that value is concentrated in the Islamic banking sector, which has achieved systemic importance in at least 11 jurisdictions. The need for financial safety net arrangements in the IFSI was also stressed in April 2010 by the joint IFSB–IRTI–IDB report entitled Islamic Finance and Global Financial Stability. The report identified eight building blocks aimed at further strengthening the Islamic financial infrastructure at the national and international levels to promote a resilient and efficient Islamic financial system. The third building block relates to the strengthening of the financial safety net mechanism comprising a Sharī'ah-compliant lender of last resort (SLOLR) and a Sharī'ah-compliant deposit insurance scheme. These, together with prudential supervision, present key components of the financial safety net arrangements for sustaining financial stability, especially when confronted with a financial shock.

The implementation of a well-designed SCDIS[90] for the IFSI, however, is particularly challenging given the specificities of the Sharī'ah contracts and funding structures of institutions offering Islamic financial services. The principles of Sharī'ah, which govern the IFSI, mandate that the necessary provisions of financial safety nets for Islamic banks must be Sharī'ah compliant.

Extending conventional DIS protection to Islamic banks presents several challenges, including: (i) issues in the underlying principles of conventional deposit insurance (excessive Gharar, Riba and so on); (ii) the treatment and insurability of deposits accepted under profit-sharing (and/or loss-bearing) contracts; (iii) the priority of claims of different types of deposits collected by Islamic banks; and (iv) the role of the deposit insurance fund in resolution.

Nonetheless, an SCDIS has the potential to promote stability and resilience in the IFSI, as it enhances depositor confidence during times of economic shocks and general market stress. *Maqāsid al*-Sharī'ah, or the fundamental objective of Sharī'ah, is to promote and protect the interests of all human beings and avert any harm that may affect their well-being. Financial safety nets, including DIS, aim to promote financial stability and prevent bank failures, and are therefore essentially tools to protect an economy from output losses and depositors from losing their funds. Thus, the underlying objective of such schemes is in compliance with Sharī'ah and can be categorised under "protection of wealth" among the five essential necessities of *maqāsid al*-Sharī'ah.

(c) The implementation modalities of SCDIS

The IFSB Secretariat conducted a survey of member RSAs between July and August 2014 to: (i) determine the current status of SCDIS; (ii) identify countries' experiences in developing and implementing SCDIS; and (iii) ascertain the key issues and challenges faced by central banks/monetary authorities in the development and implementation of SCDIS. The results of the survey[91] identified four jurisdictions (Bahrain, Malaysia, Nigeria and Sudan) where an SCDIS was already implemented and in effect. Additionally, a fifth jurisdiction (Jordan) has drafted its modality and corresponding law for an SCDIS and this is expected to be in operation in the very near future.

Among the five jurisdictions that operate or are in the process of starting operation of an SCDIS, three have based their SCDIS structure on the Sharī'ah-compliant contract of *takāful* (Sudan, Bahrain and Jordan); the other two jurisdictions (Malaysia and Nigeria) have based it on the *kafālah bi al-Ajr* contract.

- In the *kafālah bi al-Ajr* model, the IIFS pay a fee to the deposit insurer in exchange for protection of deposits; this fee is owned by the deposit insurer. In the event of failure of a member IIFS, the deposit insurer is responsible for making reimbursements from its own funds to cover eligible deposits.

- In contrast, in the *takāful* model, the deposit insurer is only an agent that operates and manages pool(s) of funds that are collected as contributions by participating IIFS (and IAHs) in the SCDIS. In the event of a member failure, the reimbursements for insured deposits are made from the respective *takāful* funds that are managed by the deposit insurer.

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[89] Data for the banking and *takāful* sectors are as of 1H2015, while for *sukūk* and funds the data are as of 11M15. See Table 1.1.1 and its explanatory notes for more details.
[90] The term "deposit" in this section has been used in a general sense, where it encompasses all types of funds collected by Islamic banks from individual and business customers, including those generated on the basis of partnership contracts (*muḍārabah*/*wakālah*) such as unrestricted and restricted PSIAs.
[91] The IFSB survey results were discussed at length in the previous year's stability report, IFSI Stability Report 2015.

The IFSB survey and further follow-up communications with these five jurisdictions have indicated some variations in the operational practices of these SCDIS. Table 2.2.3.2.1 summarises the selected features of SCDIS as operationalised in the five jurisdictions that currently operate, or are in the process of starting to operate, the scheme.

Table 2.2.3.2.1
Selected Features of Sharī'ah-compliant Deposit Insurance Schemes

	Bahrain	Malaysia	Nigeria	Sudan	Jordan
Year established	2011	2005	2011	1996	In process
Rationale for establishment	To develop the current post-funded scheme and replace it with a new pre-funded scheme to bring deposit protection more closely in line with international best practices	To allow the depositors of Islamic member banks to enjoy the same protection accorded to the depositors of conventional member banks	To cater for the (potential) depositors of IIFS that were about to be licensed at that point in time by the central bank	To participate in the stability and soundness of the banking system by protecting depositors	Currently, Jordan runs a conventional DIS which is compulsory for the commercial banks and optional for IIFS. The SCDIS will be compulsory for IIFS.
Categories of IIFS covered	Full-fledged Islamic commercial banks	Full-fledged Islamic commercial banks and Islamic windows	Full-fledged Islamic commercial banks, Islamic windows and Islamic microfinance banks	Full-fledged Islamic commercial banks and Islamic investment banks	Full-fledged Islamic commercial banks
Types of accounts protected	Islamic deposits and unrestricted investment account	• Savings account (*Wadī'ah*, *Qarḍ*) • Current account (*Wadī'ah*, *Qarḍ*) • Commodity *Murābaḥah* account (*Murābaḥah*)	• Demand deposit (*Qarḍ*) • Savings (*Wadī'ah*) • Investment account (*Muḍārabah*)	• Current account (*Qarḍ*) • Investment account (*Muḍārabah*)	Islamic deposits and unrestricted investment account
Who is covered	Individuals (local customers) and foreign customers	Individuals (local customers), corporates (businesses), foreign customers and others	Individuals (local customers), corporates (businesses), foreign customers and others	Individuals (local customers), corporates (businesses) and foreign customers	Residents and non-residents (individuals and corporates)
Underlying principle	*Takāful* mechanism	*Kafālah Bi al-Ajr* (guarantee with fee)	*Kafālah Bi al-Ajr* (guarantee with fee)	*Takāful* mechanism	*Takāful* mechanism
Contributors	IIFS	IIFS	IIFS	IIFS, IAHs, Central Bank and Ministry of Finance	IIFS, IAH and Ministry of Finance
Nature of the scheme (pre-funded or post-funded)	Pre-funded	Pre-funded	Pre-funded	Pre-funded	Pre-funded

	Bahrain	Malaysia	Nigeria	Sudan	Jordan
Coverage limit	BHD 20,000/-	MYR 250,000/-	NGN 500,000/-	Not specified; recommended that the entire amount of deposits are covered, provided that the fund has sufficient resources	JOD 50,000/-

The respective treatment in terms of SCDIS coverage of PSIAs is particularly noteworthy:

- In Jordan, the UPSIAs (unrestricted PSIAs) are split into uninvested portions and invested portions, with the SCDIS protection of the former being paid for by contributions by IIFS and the latter paid for by contributions by IAHs. In addition, RPSIAs (restricted PSIAs) are not protected by the SCDIS.

- In Sudan, all investment accounts are eligible for SCDIS protection and the contributions are paid for by IAHs only. IIFS are not involved.

- In contrast to both Sudan and Jordan, the Bahraini model does not require IAHs to make contributions for according protection of investment accounts; the contributions to SCDIS for protection of both Islamic deposits and UPSIAs are by IIFS only. On the other hand, and consistent with Jordan, the Bahraini SCDIS does not accord protection to RPSIAs.

- Of the two jurisdictions with *kafālah bi al-Ajr*-based SCDIS, investment accounts are not protected in Malaysia, while they are protected in Nigeria.

Among all five SCDIS models, there also exist some differences in terms of governance structures, investment strategies, risk assessment frameworks, coverage limits of the deposits protected, and so on. The IFSB has recently released a detailed study on this topic entitled Strengthening the Financial Safety Net: The Role and Mechanisms of Sharī'ah-compliant Deposit Insurance Schemes, where further information on this subject can be obtained.[92] This Working Paper also further notes that a number of other jurisdictions have expressed interest in developing SCDIS in the near future.

(d) Conclusion

The discussion above highlights the differing operational models of SCDIS, resulting in variations in models and approaches for the implementation of SCDIS. Aside from the Sharī'ah considerations above, due care needs to be given to ensure that SCDIS comply with international principles for effective deposit insurance systems, with such modifications as are necessary to deal with the specificities of Islamic finance. The latest standard in this regard is the recently revised Core Principles for Effective Deposit Insurance Systems (discussed above).[93]

The form and parameters of an SCDIS will depend on the circumstances of individual jurisdictions, but the experience of those jurisdictions that have already adopted an SCDIS indicates that there are no insuperable Sharī'ah issues, in terms of coverage, contributions or operation. There are, however, some Sharī'ah and operational issues to be dealt with and, since most of the existing SCDIS have not yet been tested in a real failure, it is likely that new lessons will emerge when cases arise.

2.2.3.3 Consumer Protection in Islamic Finance

The GFC paved the way for a greater focus on and policy measures for financial consumer protection, due to the fact that malpractices in financial transactions, infringement of customer rights by banks and other financial institutions, information asymmetries and cognitive biases of the financial customers played an important role in the advent of the crisis. As reflected in subsequent policymaking, financial consumer protection has become an area of priority in the political agendas of governments and international standard setters such as the BCBS, IOSCO and IAIS. Moreover, the G-20's High-level Principles on Financial Consumer Protection (2011) include transparency, impartiality and reliability as core principles.

[92] This Working Paper is available free-to-download at: www.ifsb.org/sec03.php.
[93] Regarding SCDIS, the IADI (2014, p. 16) states: "Although the Core Principles set out in this document are generally applicable to guide the establishment of an effective IDIS [SCDIS], they do not specifically take into account Islamic requirements and the unique design features of an IDIS [SCDIS]. For this reason, a set of IADI Core Principles for Effective Islamic Deposit Insurance Systems will be developed in a separate document by IADI, in collaboration with the relevant Islamic standard setting bodies or organisations with similar mandates."

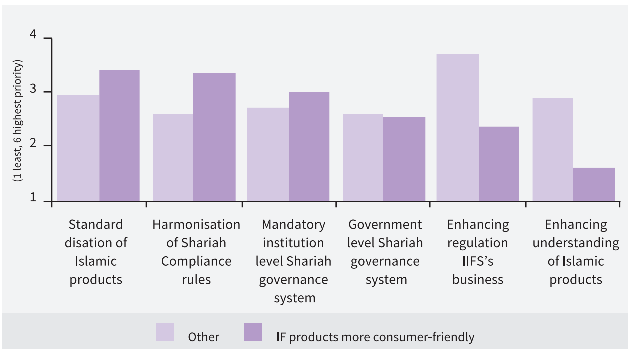
While economic agents in neoclassical models are assumed to be well-informed and rational, both the empirical evidence and repercussions of the GFC underline that this is just an idealised assumption that does not explain the real world. The main findings of behavioural economics illuminate that economic agents have limited information-processing capabilities, and cognitive biases. This suggests that consumer protection should not be confined to transparency and disclosure regulations, but should also encompass the provision of pre-processed and impartial information to support consumers in their financial decision making. A comprehensive consumer protection policy design is expected to include three realms of intervention: (a) decision support and advice to consumers in order to help them choose financial instruments that meet their needs; (b) regulation and supervision of financial products and service providers; and (c) dealing with legal matters, disputes and defaults of financial service providers.

Similar to its conventional counterpart, regulators and policymakers have started to take steps towards better consumer protection within the scope of Islamic financial services. In principle, Sharī'ah products are expected to be more consumer friendly. Despite the fact that Islamic finance is based on principles of ethics, transparency and fairness, consumer protection is still important for the industry due to the existence of issues such as the suitability of financial products for the purpose of the consumer, clarity of benefits and risks of products (language of contracts), protection against mismanagement, and Sharī'ah non-compliance risks. Indeed, all measures of financial consumer protection in the conventional system are also applicable in the realm of Islamic finance. One additional issue that exists in Islamic finance but not in conventional finance is the requirement of Sharī'ah compliance in financial products. But this is not an easy task owing to the fact that Sharī'ah views on a product may not be unique and standardised. One such example is that while the smoothing of profit payouts for UPSIAs is quite widespread, it raises eyebrows of accountants, Sharī'ah scholars and sometimes RSAs, because this practice implicitly transforms a profit- and loss-sharing instrument so that it closely resembles a conventional deposit in economic substance. Another example is where the use of a literalist approach to Islamic contracts may give rise to more hardship for customers than their conventional counterparts. In the case where a house is financed by a conventional loan, the bank can claim the outstanding amount and past interest payments if the contract is terminated early. On the other hand, in the case of a *murābaḥah*-based loan contract, the customer owes the loan and the profit markup that is calculated for the whole financing period. In such a case, the burden by the conventional loan is smaller than the murābaḥah contract because the latter also covers future markup payments. The aforementioned examples illustrate that unsuitable products may not be in the best interest of the consumer and may even lead to hardship..

As the global standard-setting body for prudential regulation and supervision of the Islamic financial services industry, in 2014 the IFSB conducted a survey on consumer protection in Islamic finance in order to identify key aspects of the existing regulatory framework, practices and regulations to ensure consumer protection among IFSB members. The IFSB received responses from a total of 38 RSAs from 22 countries.

One of the most pronounced findings from the survey is that 73% of the responding RSAs have a mandate for financial consumer protection, which number has since increased. (For instance, Saudi Arabia and Kuwait have updated their regulations.) On the other hand, as per the survey results, around 59% of the RSAs have oversight bodies explicitly responsible for financial consumer protection, whereas the G-20's High-level Principles on Financial Consumer Protection of October 2012 recommended that there should be oversight bodies (dedicated or not) explicitly responsible for financial consumer protection, with the necessary authority to fulfil their mandates.

Chart 2.2.3.3.1
Distribution of Priority of Policy Options to Upgrade Consumer Protection System*



Source: Consumer Protection in Islamic Finance Survey.
**"Other" encompasses those respondents who consider Islamic financial products as being either less consumer-friendly than, or at the same level as, their conventional counterparts.*

The survey reveals important perception patterns among the surveyed RSAs about the degree of consumer-friendliness of Islamic products. For example, only half of the RSAs agreed that Islamic financial products are more consumer-friendly than conventional ones, while the remainder consider that Islamic financial products are less consumer-friendly than, or at the same level as, their conventional counterparts. Among those respondents who do not consider Islamic financial products as being more consumer-friendly, complexity of the products was quoted as the main reason.

An interesting finding from the survey relevant to the perception of the consumer-friendliness of Islamic finance products is the differing perceptions by RSAs of the urgency of the need for policies to further upgrade their financial consumer protection systems. According to Chart 2.2.3.3.1, those RSAs that consider Islamic finance products are more consumer-friendly indicated that standardisation and harmonisation are much more important for Islamic finance. On the other hand, those RSAs that consider Islamic finance products are not more consumer-friendly compared to their conventional counterparts focus on regulation and financial education pillars as priority areas. From this decomposition, it seems appropriate to generalise that perception of consumer friendliness directly affects the type of policy action favoured.

2.2.3.4 Comparative Study on the Implementation of Standards

A common problem for standard setters is weak implementation of standards by national authorities. This is also an important issue in Islamic finance. While there may be an inclination to implement the standards and to see the results in a short time frame, this may be unattainable in particular cases due to a number of reasons such as legal and structural issues that may sometimes be beyond the full control of RSAs. This has led to greater focus on standards implementation by all the international standard-setting bodies in the aftermath of the GFC. In the light of this, the IFSB undertook a piece of research on standards implementation, with support from the Asian Development Bank (ADB). This research was published in October 2015.[94]

There is limited research on the implementation of standards, especially in emerging markets and developing economies (EMDEs). This is even more the case in Islamic finance. Furthermore, the new climate in the post-crisis era renders earlier research of limited relevance. However, two studies – the FSB's Monitoring the Effects of Agreed Regulatory Reforms on EMDEs (2013) and the Working Paper on Impact and Implementation Challenges of the Basel Framework for Emerging Market, Developing and Small Economies by the Basel Consultative Group (BCG) of the BCBS (2014) – indicate that the different stages of development of financial markets and their legal and regulatory infrastructure pose problems for all standard setters. Therefore, finding ways for the EMDEs to "deconstruct" international standards and to prioritise implementation in accordance with local priorities is of great importance for the RSAs. Implementation of technical standards should also be accompanied by institutional development.

While Islamic finance also shares some of these problems, it has some specific features of its own. Given these features, the study is aimed at examining the main factors explaining why some authorities have more difficulty in implementing the IFSB standards compared to implementing its conventional counterparts' standards. It considers these factors both within the RSAs and in the standards themselves.

Difficulties in implementation of standards may stem from the structure and context of the standards, the institutional capacity of the RSAs, or general institutional scaffolding in the jurisdiction. To examine these factors, the study employs the IFSB's standards implementation survey, with responses from 36 RSAs in 2014, and discussions with RSAs of three countries that had been identified as possible recipients of ADB technical assistance (Bangladesh, Indonesia and Pakistan) and four countries with a strong record of implementation of IFSB standards (Bahrain, Jordan, Malaysia and Sudan). The study focused on four well-established standards applicable to the banking sector and with long experience of implementation. These standards are:

- IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services (IIFS)
- IFSB-4: Disclosures to Promote Transparency and Market Discipline for IIFS
- IFSB-5: Guidance on Key Elements in the Supervisory Review Process of IIFS
- IFSB-10: Guiding Principles on Sharī'ah Governance Systems for IIFS.

The IFSB Implementation Survey in 2014 is the first source for understanding the main factors affecting implementation problems from the perspective of RSAs. While the small sample size and self-reporting bias – which is a common problem in the surveys – are two main drawbacks of the dataset, the survey does reflect perceptions from a range of RSAs.[95]

Table 2.2.3.4.1 shows the ranking of some of the questions in the last three IFSB Implementation Surveys (2011, 2013 and 2014). In these surveys, the respondents were asked to assess various challenges in implementing the IFSB standards on a scale of 1–4, with a lower figure indicating a more significant challenge. One new challenge was included for the first time in 2014. Although the rankings have changed relatively little over the years, the response to the new question in 2014 suggests that the most important issue for the RSAs is the need to change the legal framework, defined in the survey as aspects of regulation that require external approval,

[94] Comparative Study on the Implementation of Selected IFSB Standards is available for download from the IFSB website under the Reports/Research/Proceedings section. Alternatively, it can be downloaded directly with the following link: www.ifsb.org/docs/WP-04-Comparative%20Study%20(final).pdf.
[95] Fuller data from the survey was published in the 2015 Stability Report.

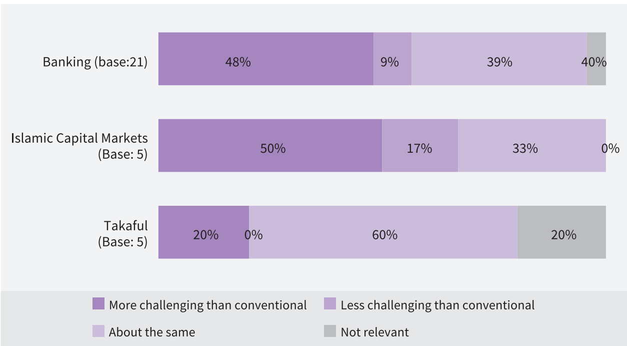
rather than being within the power of the RSA. It is also observable from the detailed survey data that need to change the regulatory and supervisory framework (those elements within the authority of the RSA), followed by lack of human capital, are issues considered almost as important as the legal framework issue.

Table 2.2.3.4.1
Significance of Various Challenges in Implementing IFSB Standards

Challenges	Rank		
	2011	2013	2014
Need to change legal framework			1
Need to change regulatory and supervisory framework	1	1	2
Lack of personnel with relevant knowledge/experience/training	2	2	3
Cost of implementation	3	3	4
Lack/poor quality of data to support implementation of the standards	4	5	5
Institution size and complexity	5	4	6

Source: Comparative Study on the Implementation of Selected IFSB Standards.

Chart 2.2.3.4.1
Comparison of Challenges in Implementing IFSB and Conventional Standards



Source: Comparative Study on the Implementation of Selected IFSB Standards.

The IFSB standards are based on corresponding conventional standards, so the survey also attempts to disclose to what degree the standards differ from their conventional counterparts with respect to difficulty of implementation. This could in principle be due to, where relevant, the nature of the IFSB standards themselves, or to institutional reasons such as lack of capacity in Islamic finance or lack of political support. Chart 2.2.3.4.1 indicates that the IFSB standards are more challenging to implement. However, due to the small sample size, the results for *takāful* and Islamic capital markets should be evaluated with caution.

Apart from the IFSB Implementation Survey, discussions with the RSAs also provided important information. These discussions revealed that successful implementers have some differences in their implementation approaches compared to less successful ones.

Implementation generally follows a more-or-less standard pattern. First, a senior line manager or a committee takes the decision for implementation. A project team responsible for developing the details and overseeing the translation of the standard is then assembled. There is also consultation with the industry about the implementation. The process concludes when a final version of the legislative instrument is prepared and approved, usually by the authority that made the original decision to implement.

One key difference is that successful implementers have a working presumption that IFSB standards will be implemented, and their dialogue with industry takes place in that context. In less successful implementers, this presumption does not exist. Similarly, although RSAs vary in the extent to which they have requirements to consult Sharī'ah advisers, in the more successful implementers consultation tends to assume that the standard will have had proper Sharī'ah review, and discussion is therefore likely to be confined to a few specific points.

In the jurisdictions with a dual banking system (conventional and Islamic), having a top-level legal framework seems to be an advantage (although this is inconclusive), due to the fact that this framework may allow common elements between the two sets of standards to be translated into regulation only once.

In some RSAs, institutional capacity is perceived as an issue. Furthermore, in jurisdictions with a limited Islamic finance industry, the smaller industry base limits the industry's resources available to make inputs during the process. So, the insufficient capacity issue covers not only the RSAs but also the industry as a whole. As another aspect of institutional capacity, the presence of a separate policy team for Islamic banking avoids competition for resources between Islamic and conventional standards. However, only larger jurisdictions with a very substantial Islamic finance presence are likely to be able to justify this.

For the prudential standards in Islamic finance issued by the IFSB, there is a clear demand by the RSAs for greater support for implementation. Indeed, the new IFSB Strategic Performance Plan 2016–2018 encompasses an expanded programme to assist the member jurisdictions in implementing the IFSB standards through a variety of initiatives that include increasing the number of workshops, expanding technical assistance support, and introducing e-learning modules for various IFSB standards.

The findings from the survey and discussions with the RSAs give important clues and suggest directions for the IFSB on how to further develop its standard-setting work and support standards implementation. In the light of the surveys and the discussions, some of the important ways forward can be summarised as follows:

- Different jurisdictions have different stages of development in their financial markets and legal/regulatory scaffolding. For this reason, ways should be found for the markets to "deconstruct" international standards and implement them in accordance with local priorities. Moreover, implementation of technical standards needs to be accompanied by institutional development, as they complement each other to a great extent. For those jurisdictions that are encountering Islamic finance for the first time or have done so only very recently, the existence of supporting institutions, such as protection of property rights, and institutional development are very important factors for success.
- Commitment is the key to successful implementation. As underlined above, successful implementers start with the presumption that international standards in general, and IFSB standards in particular, will be implemented.
- Some jurisdictions will want to implement standards for their conventional and Islamic sectors on similar timescales. Given this fact, the IFSB should be in a position to respond quickly to the process of implementing and revising international standards. To do so, the IFSB standards agenda should be planned in the light of the agendas of the conventional standard setters, and the standards should at least mirror the coverage of the conventional standards, except where elements are clearly not relevant to Islamic finance.
- A jurisdiction's active involvement in the standards development process brings extra benefits after the standard is implemented. The IFSB should therefore continue to allow participation in its working groups to jurisdictions that will use them primarily for learning, but learning with an eye to implementation.
- Some jurisdictions want IFSB standards to be "implementation ready", with minimal further development or exercise of discretion due to reasons such as limited organisational capability and political issues.
- Language in IFSB standards should be used consistently and precisely.
- Language in IFSB standards should be used consistently and precisely.

3.0 ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

3.1 OVERVIEW OF THE GLOBAL ECONOMIC AND FINANCIAL CHALLENGES

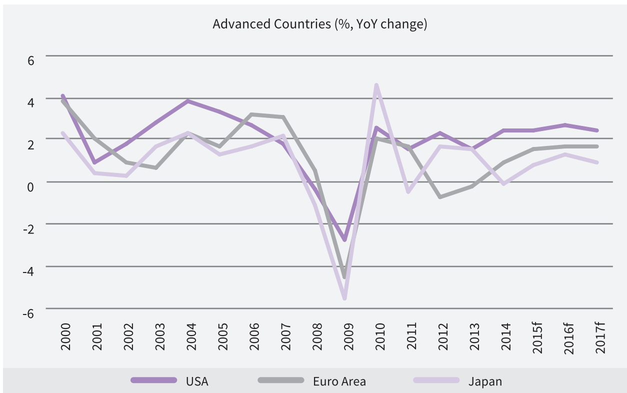
This section reviews significant economic and financial developments at the global level since the publication of the IFSB's IFSI Stability Report 2015, and then briefly evaluates the main challenges stemming from these developments that may generate repercussions for the Islamic finance industry in 2016.

Growth Outlook

The global economy grew at a moderate pace with significant rate of growth variability among the geographical regions. In 2015, global growth is projected to be 3.1% by the International Monetary Fund,[96] 3.0% by the Organisation for Economic Co-operation and Development, 2.4% by the United Nations [97] and 2.8% by the World Bank,[98] all of which projections are lower than forecasted by these institutions in previous reports. At the same time, rates of growth are uneven – and seemingly diverging – across the developed and developing worlds. In the advanced economies, growth rate expectations are slightly higher in 2015 compared to 2014, with growth projected to be 2.1% in 2016 and to remain at that level in 2017.[99] In contrast, the economic growth rate in all EMDE groups[100] is projected to be lower in 2015 than in the previous year (see Charts 3.1.1 and 3.1.2) and to rise to 4.3% and 4.7% in 2016 and 2017, respectively.

Among the advanced economies, the US has had, on average, the most robust and sustained growth rates since 2009. Its average growth rate is 2.3% over the 2010–2015 period, compared to only 0.8% in the Euro area and 1.4% in Japan. Lower energy and commodity prices, milder fiscal drag, improved balance sheets in the banking sector and positive prospects in the housing market have contributed to growth recovery in the US. Moreover, the unemployment rate has halved to 5% from its post-crisis level. This was an important benchmark for the Federal Reserve ("the Fed"), which raised the Fed funds rate by 25 basis points to 0.25% during its FOMC meeting held on December 16th, 2015. On the basis of these positive developments, the IMF projects growth to be 2.6% in 2015, the highest rate in the post-crisis period, and 2.8% in 2016.[101] In the Euro area, growth picked up in 2015 thanks to strengthened domestic demand, which is a reflection of low oil prices, favourable financing conditions, and better export performance supported by depreciation of the Euro. Improved credit conditions and credit growth, following years of contraction, have supported domestic demand and investment as well, while credit availability still remains tight for some countries in the Euro area. Weak growth prospects in the emerging markets, especially in China, are expected to limit further export growth. While the prospect of contagion effects from the Greece crisis still remains an issue, the third bailout programme, which was agreed in August 2015 and amounts to USD95 billion, is expected to tame Greece's immediate funding pressures. The European Cerntral Bank (ECB) expects the growth rate to be moderate in the Euro area – around 1.5% in 2015 and 1.7% in 2016.[102] In Japan, despite rising corporate profits and the government's stimulus programme, private consumption contracted and export performance was not robust in 2015. However, negative growth of –0.1% in 2014 is expected to turn into a positive growth rate of 0.6% in 2015, and to 1% in 2016, with the help of higher equity prices stemming from recent QE policies and lower oil and commodity prices.[103]

Chart 3.1.1
GDP Growth by Country Grouping



Source: World Development Indicators, World Bank Global Economic Prospects 2016.

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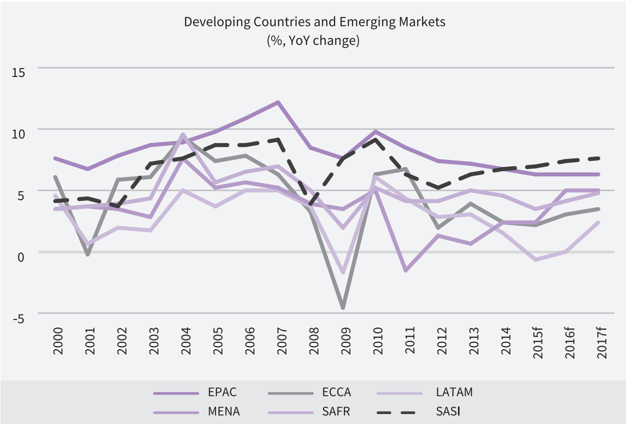
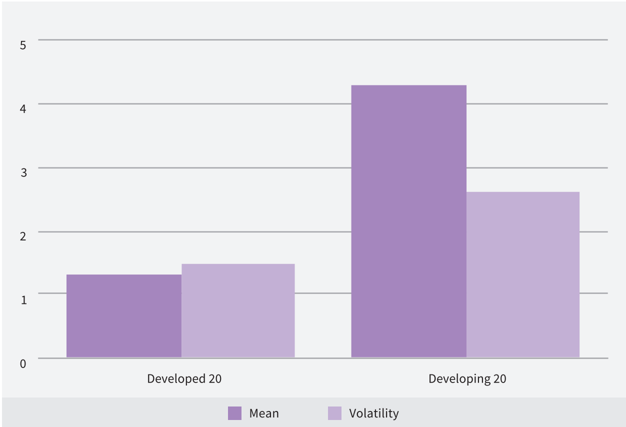
96 IMF (2015), *World Economic Outlook*, January.
97 UN/DESA (2015), *World Economic Situation and Prospects 2016 Report.*
98 WB (2016), *Global Economic Prospects.*
99 WB (2016), *Global Economic Prospects.*
100 In line with the World Bank, we define five main developing country groups, namely: East Asia and Pacific (EPAC), East Europe and Central Asia (ECCA), Latin America (LATAM), Middle East and North Africa (MENA) and Sub-Sharan Africa (SAFR).
101 IMF (2015), *World Economic Outlook,* October.
102 ECB (2015), *Euro-System Staff Macroeconomic Projections for the Euro Area,* December.
103 IMF (2015), *World Economic Outlook,* October.

Chart 3.1.2
GDP Growth by Country Grouping



Source: World Development Indicators, World Bank Global Economic Prospects 2016.
In the graph, EPAC: East Asia and Pacific, ECCA: Eastern Europe and Central Asia, LATAM: Latin America and Caribbean, MENA: Middle East and North Africa, SAFR: Sub-Saharan Africa, SASI: South Asia.

Chart 3.1.3
Volatility of Growth (2010–2015H1)



Source: UN World Economic Situation and Prospects 2016.

Despite slightly better growth rates in the advanced economies, growth in the EMDEs is projected to slow down in 2015 and then to pick up gradually in 2016–2017. According to the World Bank's projections, growth in 2015 will be 4.3% in the developing countries, a decline from 4.9% in 2014. Moreover, the projected growth figures have a wide spectrum among the country groups, ranging from –0.7% in Latin America to 7% in South Asia (see Chart 3.1.2). Apart from the fact that the average growth rate in the EMDEs in the post-crisis period is far below that experienced during the 2000–2008 period, uncertainty in the global economy seems to lead to higher volatility in this set of countries compared to the advanced economies. Chart 3.1.3 compares the mean and volatility, which is measured as standard deviation, of growth in the 20 largest developed and developing countries between 2010 and 2015H1.[104] The chart provides important insights on the more volatile growth environment of the developing world. On the other hand, the 2016 figures forecast a rebound to 4.5% in the event that the downside risks are not realised.

EMDEs have experienced one of the longest growth episodes since the beginning of the 2000s, with an average rate of growth of over 6% during that time. Having said that, the average growth rate for this group of countries has declined in the post-crisis era. As stressed in the Bank for International Settlements' Annual Report for 2015, this slowdown may cast a prospective shadow on EMDEs for at least three reasons: (1) high commodity prices or strong capital inflows may have exaggerated the true potential output level of this group of countries; (2) financial booms, leading to misallocation of resources, may have weakened productivity; and (3) credit booms, and subsequent hefty debt service burdens, can impede medium-term growth.[105]

Box 3.1.1 Unconventional Monetary Policy at the Lower Bound: Recent Developments

Following the "taper tantrum" in 2013, a sustained communication strategy by the Federal Reserve is widely credited with the smooth implementation of its first rate hike in nine years, on 16 December 2015, with minimal or no market disruption. However, since then, a number of developments have brought back to the forefront issues that have simmered on and off, featuring divergent views on the international transmission of monetary policy, the relevance and priority of financial stability issues and, indeed, the effectiveness of unconventional monetary policy (UMP) practiced at the lower bound with nominal interest rates close to zero in key advanced economies.

It should be stressed that there is wide recognition that US monetary policy was appropriately targeted towards attaining the dual mandate of the Federal Reserve in terms of reducing the output gap in the US economy, while moving inflation towards its target level. There is also recognition that the Fed has faced a challenge recently in aligning its path for policy adjustment towards achieving its mandate - in view of the more rapid fall in the

[104] The developed sample is composed of the United States, Japan, Germany, United Kingdom, France, Italy, Canada, Australia, South Korea, Spain, Netherlands, Switzerland, Sweden, Belgium, Taiwan, Norway, Austria, Denmark, United Arab Emirates and Singapore. The developing countries and emerging markets sample is composed of China, Brazil, India, Russia, Mexico, Indonesia, Turkey, Saudi Arabia, Nigeria, Poland, Argentina, Iran, Thailand, Colombia, South Africa, Malaysia, Egypt, Philippines, Chile and Pakistan.
[105] BIS (2015), Annual Report 2015.

unemployment rate towards its target, in relation to the slower reduction in the output gap, in an environment in which core inflation was slow to show an uptick.

While the Fed was squarely focused on achieving its domestic mandate through UMP, other institutions, including the BIS and central banks in some major emerging market economies (EMEs), have stressed the international transmission of monetary policy in an environment in which capital flows appear to be more volatile. In the new environment we face what is described as "risk on/risk off" scenarios, marked by volatile capital flows as financial markets adjust to the withdrawal of UMP and the normalization of interest rates in advanced economies. These sudden shifts in cross border financial flows have proved challenging to many EMEs.

The recent introduction of negative real interest rates as a policy target for a number of central banks, including Japan and Sweden amongst others, seems to have introduced new dimensions to the understanding of the prospects for UMP. Thus, while the consensus view among central banks in advanced economies and of the IMF is that negative real interest rates are "accommodative", this view faces two distinct sets of recent developments that have come to the fore after the Fed rate hike.

First, the turmoil in banking stocks in a number of economies in early 2016 has highlighted private sector concerns about the longer term impact of negative real interest rates on the banking sector. As has been noted by a number of observers, this raises the challenge of reconciling market volatility and turbulence with the medium term outlook of the authorities. Second, is the emergence of views within the Fed of the relevance of the international transmission of monetary policy, a view advocated by a recently appointed Governor, Lael Brainard. Two quotes from her illustrate the issue at hand.

"although the U.S. real economy has traditionally been seen as more insulated from foreign trade shocks than many smaller economies, the combination of the highly global role of the dollar and U.S. financial markets and the proximity to the zero lower bound may be amplifying spillovers from foreign financial conditions....
"Financial channels can powerfully propagate negative shocks in one market by catalyzing a broader reassessment of risks and increases in risk spreads across many financial markets...Recent events suggest the transmission of foreign shocks can take place extremely quickly such that financial markets anticipate and indeed may thereby front-run the expected monetary policy reactions to these developments." **(Governor Lael Brainard; At the Monetary Policy Forum, New York; 26 February 2016). <www.federalreserve.gov/newsevents/speech/brainard/20160226>**

Elements of these views featured during the Congressional testimony of the Fed's chairman in 2016, and are reflected in the January minutes of the Federal Open Market Committee (FOMC) which indicates that the US monetary authorities will be assessing international financial developments for their impact on the domestic US economy. While it is too early to say that this policy perspective vindicates the views of the EMEs in recent years, who have called for this wider consideration, it does suggest that there is a growing recognition that the financial conditions in the US may be more sensitive to international financial conditions. This view rests on research that indicates that at near-zero interest rates monetary policy changes in one economy are less likely to result in boosting domestic demand; the more likely result is the shift of demand from one economy to another. For a succinct statement on this issue, we go once again to an excerpt from Governor Brainard, who has drawn attention to this research:

"It also appears that the exchange rate channel may have played a particularly important role recently in transmitting economic and financial developments across national borders….This finding could explain why the sensitivity of exchange rate movements to economic news and to changes in foreign monetary policy appear to have been relatively elevated recently."

An additional factor that may affect the pace of normalisation of interest rates in the United States is concern over inflation expectations which, should they drift downwards, carry the risk of prolonged deflation. With interest rates near zero, and the conventional tool box of monetary policy substantially if not completely used up, this would face policy makers with some difficult choices.

In this complex environment, despite the views of those who regard UMP to have entered into the realm of diminishing returns, it may be premature to conclude that UMP's days are numbered. We are left with three conclusions from this brief survey of developments. First, UMP is proving increasingly difficult to calibrate. Second, it is even more difficult to communicate. And third, what is perhaps most difficult of all, in the absence of political consensus on the use of other instruments to boost domestic demand, most notably fiscal stimulus, is giving up UMP altogether.

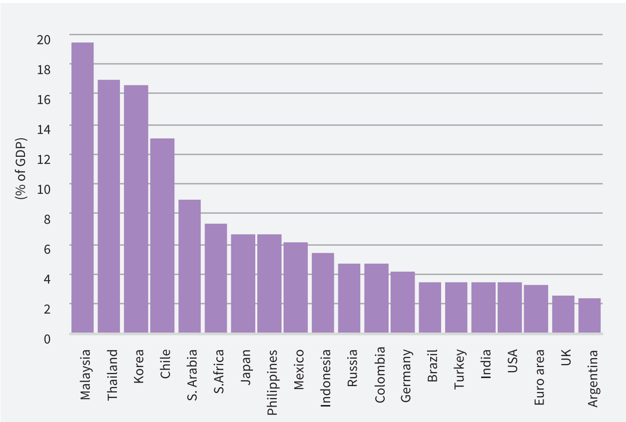
An Assessment of the Current Risks for the EMDEs

Economic outcomes in the advanced economies, and in particular in the systemically important economies, have reverberated in the EMDEs through several channels and impacted the main economic and financial variables such as capital flows, asset prices and exchange rates. These effects, in turn, have an influenced the growth prospects of the EMDEs and their prospective vulnerabilities. In addition, most of the Islamic finance markets belong to the EMDE set. Due to these reasons, this section focuses mostly on an assessment of the factors from the lens of growth prospect in the EMDEs and the current risks they have faced.

Strong demand in systemically important economies such as the US is a source of prospective strength for emerging markets. The difficulty has been reduced growth prospects in other key economies such as China, as well as financial stability concerns arising from transmission and amplification of the effects of uncertainty in monetary policies in key economies. Faltering growth in the EMDEs is thus a reflection of a combination of factors. Among these factors, dampening global trade, the slowdown in China, low oil and commodity prices for exporters, the decline in international capital flows, geopolitical tensions, and strife in a number of countries seem to have contributed to the lower growth prospects in the emerging markets and developing countries. Prospective repercussions of monetary policies require careful analysis. First, the rise of US interest rates, to the extent that they reflect expectations of a stronger economy, are not in themselves a source of risk to the global economy. However, this issue is clouded by a number of sources of uncertainty. These include the strength of the economic recovery on the one hand, and the risks of overheating in terms of the inflation target on the other. However, uncertainty about the risks to the US economy in terms of overheating, may well be a lower category of risk in the light of feedback effects from the international economy to the US domestic economy arising from financial market volatility of the type seen in both 2015 and 2016. This would seem to suggest the potential value of moderating the pace of interest rates increases for the moment.

The unexpected slump in global trade was a major factor which have slowed growth in the EMDEs in 2015, one of the few years in the past half-century when global trade growth has been 2% or less.[106] Apart from its level, the nature of the global trade growth differs from episodes in the past. In the aftermath of the 2008 GFC, declining global trade performance mostly reflected weak demand in the advanced countries, but in the current episode the source of the marked decline in global trade growth is a reflection of the meagre growth performance of the EMDEs (mostly China) and a sharp decline in imports by a number of countries (such as Brazil and Russia).[107] Since the onset of the 2008 crisis, China has become the locomotive of global economic growth, contributing around one-third of the total.[108] But the change in direction of the Chinese economy towards a "new normal" of more domestic-oriented and slower growth has had cross-border repercussions for the rest of the world. The direct effects have been weakening oil and commodity prices (especially metals) and dampening exports to China from the rest of the world (see Chart 3.1.4). Exchange rate depreciation in the commodity exporters emanating from the fall in commodity prices puts an extra burden on the EMDEs' economies. There are also second-order effects of weak global trade growth, with possible long-term repercussions, such as the slower expansion of global value chains and disruptions in multilateral trade negotiations.[109]

Chart 3.1.4
Trade Linkages with China (2014)*



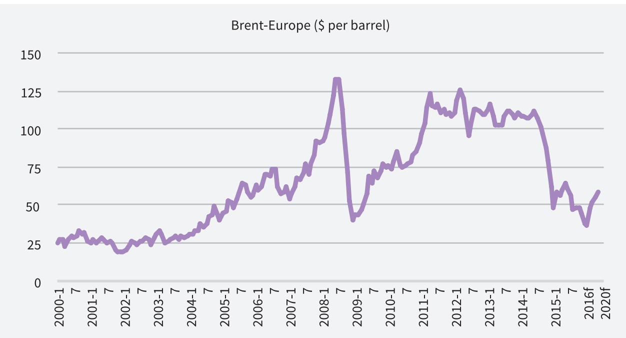
Source: OECD Database (2015).
**Calculated as total of export and import share in GDP.*

Low oil and commodity prices were also factors contributing to the faltering growth in the EMDEs. The oil price slump, which had already started in 2014, has

[106] OECD (2015), *Economic Outlook*, Issue 2.
[107] OECD (2015), *Economic Outlook*, Issue 2.
[108] Zheng Liu (2015), "Is China's Growth Miracle Over?" *Federal Reserve Bank of San Francisco Economic Letters 2015/16*, 10 August.
[109] UN (2016), *World Economic Situation and Prospects 2016.*

intensified especially in the second half of 2015, with a decline of almost 67% between June 2014 and December 2015 (see Chart 3.1.5). Under normal conditions, such as in an era of the Great Moderation, a decline in oil price is expected to have positive effects on global economic activity due to the fact that the windfall to the public finances of the oil importers possibly exceeds the negative effects on the public financing of the oil exporters and lower production costs stimulate production in other sectors for which oil is an input. Indeed, a recent IMF Working Paper estimates that the fall in oil prices could boost global growth by about 0.5 ppt in the 2015–2016 period.[110] On the other hand, weak global trade, geopolitical tensions, ongoing financial strains and accumulating vulnerabilities will possibly offset the potential gains from the lower oil prices.[111] Moreover, the fall in oil prices has also led to a sharp decline in investment in the domestic oil sector of the oil exporters and negatively affected their medium-term expectations of a pick-up in consumption. The slowdown of consumption and import demand in these commodity and oil exporters has a second-order effect as well, by negatively affecting export performance of the non-commodity exporters, such as Turkey.

Chart 3.1.5
Oil Prices



Source: US Energy Information Administration (December 2015). Historical data: https://www.eia.gov/petroleum/data.cfm, World Bank Commodity Markets Outlook 2016 (2016–2020 forecast).

In 2015, the sharp decline in capital flows has also contributed to the meagre growth performance of the EMDEs. Total capital inflows to the EMDEs was negative for the first time since 2008. The current ongoing incidence of capital outflows from the EMDEs is even more severe than that experienced during the 2007–2008 GFC in terms of volume, which reached around USD700 billion in 2015. Even setting aside China, the amount is still large and this episode is expected to be pervasive.[112]

A slump in commodity prices, sharp realignments of exchange rates, policy change expectations for the FED funds rates, heightened risk aversion, and deteriorating growth performance in commodity-exporting economies have contributed to this development. As argued by Reinhart et al. (2016)[113] in a recent paper, international capital flow cycles have had a similar pattern for the last 200 years. The last episode of global boom of capital flows lasted from 1999 to 2011 and was equivalent to an 18.3% change in US GDP, while the subsequent global bust period of 2011–2015 resulted in the equivalent of a –15.9% change in US GDP. Both the boom and bust changes were higher than the historical average of 11.7% during the boom and –12.4 during the bust. The higher amplitude of the bust is relevant to the double busts in capital and commodity markets, which can lead to imminent risks.

Interest rates are at their historical low levels, both in nominal and real terms; they are even lower than their level in the aftermath of the GFC. This is an exceptional situation in modern times. Policy rates have already reached their zero lower bound, and "shadow rates" are much below the zero rate, having moved into negative territory.[114] While shadow rates are on an upward trend in the US since 2013, considering the three biggest central banks altogether (the Fed, the ECB and the Bank of Japan), they are still very low in historical terms (see Chart 3.1.6). While the central banks view the negative interest rates as an accommodative stance, the market reaction has indicated some distance between official and private-sector viewpoints. The Fed raised the funds rate by 25 basis points to 0.25% during its FOMC meeting held on 16 December 2015; in contrast, the ECB and BOJ expanded their quantitative easing policies. On 22 January 2015, the ECB announced a massive expansion of its asset purchase programme, the Public Sector Purchase Programme (PSPP), under which the ECB would purchase sovereign bonds and securities from institutions and national agencies from March 2015 to September 2016. Concurrently, the Bank of Japan (BoJ) decided to continue its QE programme, begun in April 2013, expanding it in 2014. Recent policy actions by the BoJ, such as a 0.1% fee on deposits, have confirmed that BoJ and the ECB will be the main liquidity providers at the global level. As opposed to the QE policies and closely interconnected low interest rates episode, the growth rate at the global level is still weak and the large scale purchasing programmes seemingly have not had an appreciable impact on growth in the real sector (see Charts 3.1.7 and 3.1.8).

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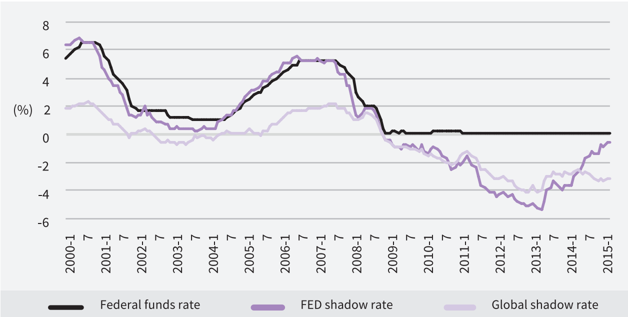
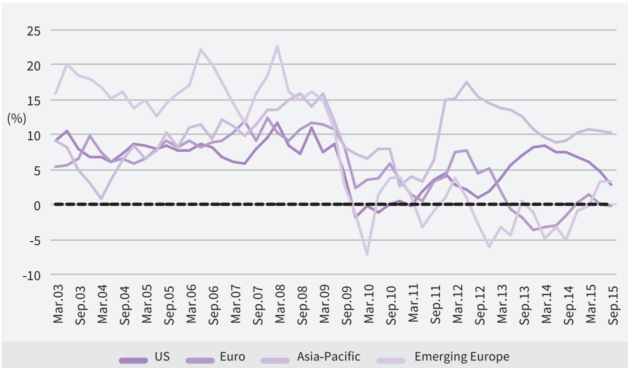
110 Aasim M. Husain et al. (2015), "Global Implications of Lower Oil Prices", *Staff Discussion Notes*, No. 15/15.
111 WB (2016), *Commodity Markets Outlook*, January.
112 UN (2016), *World Economic Situation and Prospects 2016.*
113 Carmen M. Reinhart, Vincent R. Reinhart and Christoph Trebesch (2016), *Global Cycles: Capital Flows, Commodities, and Sovereign Defaults, 1815–2015,* NBER Working Paper No. 21958, February.
114 IMF (2015) defines the shadow rate as follows: "Shadow rates are indicators of monetary policy stance and can be particularly useful once the policy rate has reached the zero lower bound (ZLB). A shadow rate is essentially equal to the policy interest rate when the policy rate is greater than zero, but it can take on negative values when the policy rate is at the ZLB. This property makes the shadow rate a useful gauge of the monetary policy stance in conventional and unconventional policy regimes in a consistent manner. Shadow rates are estimated using shadow rate term structure models."

Chart 3.1.6
Shadow and Policy Rates



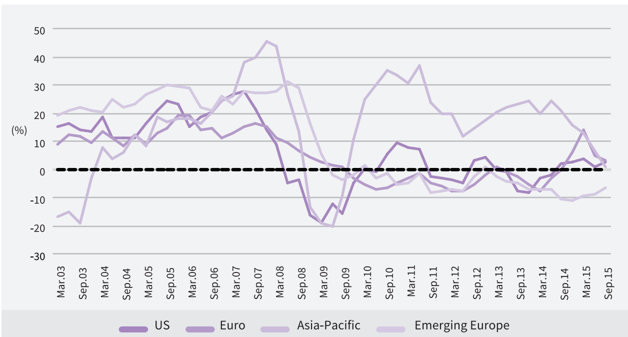
Source: IMF GFSR (2015), WB Global Financial Development Report.
**Average of FED, ECB and BoJ policy rates.*

Chart 3.1.7
Total Bank Credit (local claims, YoY growth)



Source: Bank for International Settlements (2016).

Chart 3.1.8
Total Bank Credit (cross-border claims, YoY growth)



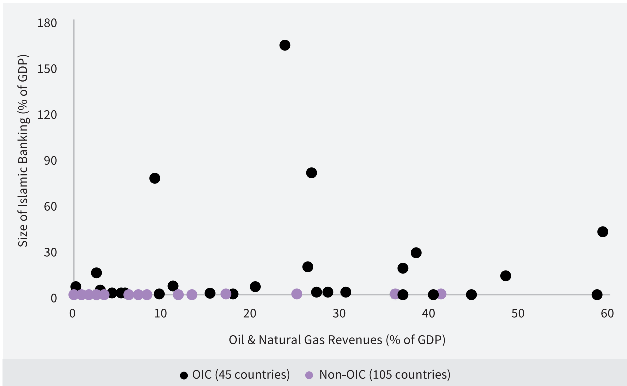
Source: Bank for International Settlements (2016).

Major Risks Ahead in 2016

In the light of the aforementioned developments, and as underlined in the IFSI Stability Report 2015, the main risks to the global economy – including the challenging business environment, concerns about a global recession still persist. In addition, developments have emerged that have the potential to aggravate the prospective risks to economic and financial stability.[115] In the rest of this section, these three new developments are expounded as imminent risk factors from the point of view of their relevance to the Islamic finance industry.

First, as mentioned above, the decline in oil and commodity prices has repercussions for the developing world. This recent trend has both introduced additional vulnerabilities and provided new opportunities for those countries in which Islamic finance has a relatively important share or is gaining momentum in the domestic financial system. As a proxy for the nexus between share of Islamic finance in the total financial system and dependence on oil revenues, Chart 3.1.9 shows that a positive association between these two variables is more "pronounced" in the OIC countries, where Islamic finance has more room to thrive. Given the positive association between share of Islamic banking in the financial system and dependence on oil revenues, we can, a priori, expect repercussions for the development of Islamic banking stemming from the slump in the oil prices. But this is only part of the story. Two possibly counterweighting effects may emerge from the decline in oil prices for oil-dependent OIC countries.

Chart 3.1.9
Oil Rents and Islamic Banking Nexus



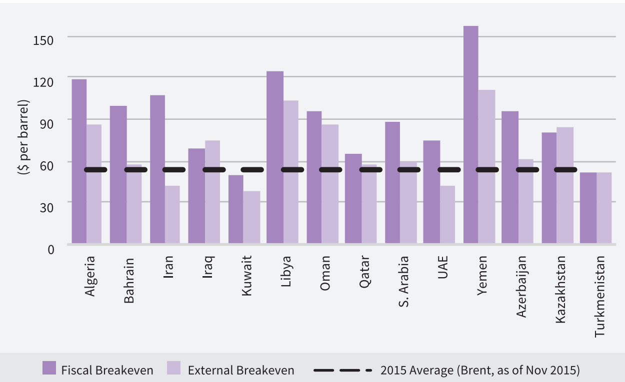
Source: World Bank Development Indicators, World Bank Islamic Banking database in Global Finance Development Report (2015).
**OIC consists of 57 countries, 45 of which are represented in the dataset.*

On the one hand, declining oil prices give rise to weaker fiscal and external positions and less room for government spending. Due to the close relationship between public-sector entities and the private sector in the GCC countries, oil prices are also reflected in corporate profitability and equity prices. Indeed, given the average oil price level in 2015, almost all of the oil-producing OIC countries (especially the GCC) are below their fiscal and external breakeven levels, indicating that current oil prices are well below those needed to bring these economies into fiscal and external balance[116] (see Chart 3.1.10). Over the years, GCC countries have enlarged their fiscal spending

[115] BIS (2015), *Annual Report 2015*.
[116] Fiscal and external breakeven prices are defined as the oil price at which the fiscal and current account balance, respectively, is zero.

to maintain their citizens' standard of living and to secure a social state that has been helped by generous oil revenues. If oil prices are expected to remain on a low level for the next number of years, governments will have to trim their budgets and this means contraction in other macroeconomic variables, such as consumption, investment and imports. This development will also have a negative effect on the reserves, which are usually the source of the sovereign wealth funds in the GCC region. This may be an obstacle to further growth of the Islamic banking, capital markets and *takāful* industries and may even generate extra risks for Islamic banks that are highly concentrated on consumer financing, real estate and commodity investments.[117] Moreover, cuts in infrastructure and development projects will certainly affect Islamic banks negatively.

Chart 3.1.10
Fiscal and External Breakeven Oil Prices



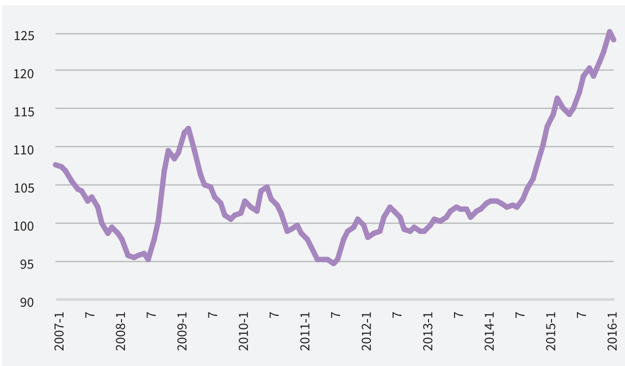
Source: IMF (2015), Regional Economic Outlook: Middle East and Central Asia, October.

On the other hand, it is not easy to sharply trim the budget given welfare state provisions in some of the GCC countries, Iran and the Central Asian states. In such a case, resorting to alternative financing instruments may gain prominence. Indeed, declining oil prices may not always have a negative impact on *sukūk* markets. For instance, Oman's long-awaited debut sovereign *sukūk* in 2015 was a reflection of tightening conditions in its macroeconomic and borrowing prospects. Moreover, declining oil prices are an opportunity for the GCC governments to initiate reforms for diversifying their economies. Private sector-led diversification attempts mean more investment needs in new areas such as manufacturing, retail and tourism. This may increase the demand for investments by the private sector and open a new door for Islamic finance.

Second, appreciation of the US Dollar since the second half of 2014 has been significant. The trade-weighted USD index increased by 21.3% between June 2014 and February 2016, according to the latest data available (see Chart 3.1.11). Steep appreciation of the USD index is mostly a product of strong US growth, the fall in oil and commodity prices, and subdued growth prospects in the Euro area and Japan. Apart from ongoing appreciation of the USD, further hikes in the Fed funds rate, the first time in almost a decade, could contribute additionally to the strong USD in 2016. As underlined by a recent IMF study,[118] past episodes of sustained USD appreciation were associated with a spur in foreign currency debt liabilities and sharp exchange rate depreciations in the EMDEs. Whereas many of the EMDEs are less vulnerable to external shocks thanks to their improved net asset positions, vulnerabilities still remain, especially in the corporate sector.

Repercussions of the appreciation will most possibly be felt in the emerging economies with high levels of foreign corporate-sector debt. Past episodes of persistent USD appreciation were associated with financial and exchange rate crises in the emerging markets (Debt Crisis in 1982, Asia Crisis in 1997, Brazil and Russia Crises in 1998). This time around, many emerging market sovereigns seem to be less vulnerable, thanks to their improved net foreign asset positions. Despite better net foreign asset positions, gross liabilities are very high in many of the emerging sovereigns[119] and this is an important factor leading to rollover and interest rate risks.

Chart 3.1.11
Trade-weighted USD Index (1997=100)



Source: Board of Governors of the Federal Reserve System (US), Trade Weighted U.S. Dollar Index: Broad [TWEXBMTH], retrieved from FRED, Federal Reserve Bank of St. Louis.

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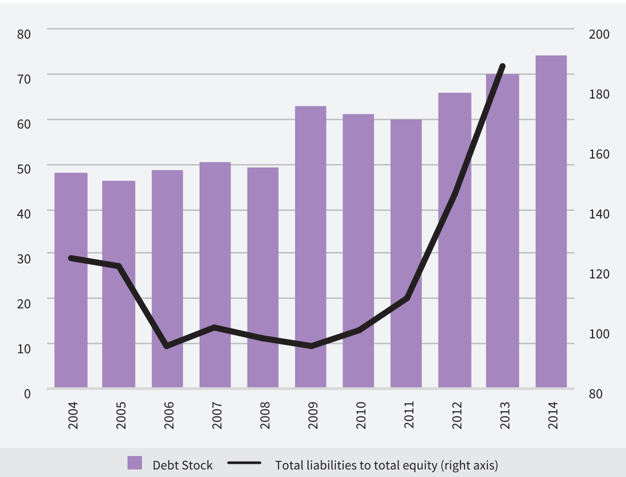
[117] IMF (2015), "Oil Prices, Financial Stability, and the Use of Countercyclical Macroprudential Policies in the GCC", Annual Meeting of Ministers of Finance and Central Bank Governors, Doha, Qatar. 10 November.

[118] Julian T.S. Chow, Florence Jaumotte, Seok Gil Park and Yuanyan Sophia Zhang (2015), "Spillovers from Dollar Appreciation", IMF Policy *Discussion Paper No. 15/2.*

[119] Currency composition of foreign assets and foreign liabilities are usually different. As long as a country does not have high USD-denominated asset positions matching its USD-denominated foreign liabilities, there are valuation effects that are usually detrimental to the external positions of emerging economies.

Despite improved positions of the sovereigns compared to past episodes, a third imminent risk factor in 2016 is skyrocketing corporate-sector debt, induced by close-to-zero interest rates, and the change in its composition. Corporate debt has more than quadrupled in a decade, reaching USD18 trillion at the end of 2014 in the emerging economies (see Chart 3.1.12). Debt-to-equity ratios are also at unprecedented levels, indicating an over-borrowing syndrome among emerging-market corporations. According to the IMF, firm- and country-specific factors play very little role in this leveraging episode, which is being propelled mainly by global factors.[120] Moreover, the leverage has risen mostly in cyclical sectors such as construction, which are much more susceptible to changes in global conditions. Finally, high corporate sector debt is usually USD-denominated in the emerging economies through accumulating a large foreign exchange exposure.

Chart 3.1.12
Emerging Market Corporate Debt (% GDP)



Source: IMF (2015), Global Financial Stability Report, October.

Apart from shifts in the level of leverage in the corporate sector, the composition of debt in the sector is also of concern. Playing a major role is the shift from bank loans to bonds and non-financial corporate bonds. Indeed, the stock of total corporate bonds has reached USD6.8 trillion, double its 2008 level; however, the growth of non-financial corporate bond stock is even more significant: it reached USD2.6 trillion in 2014, triple the level in 2008, and is continuing to accumulate rapidly.[121] While the bulk of the emerging market bond financing is in local currency, foreign currency issuance has been increasing by posing extra risks. Indeed, its share was over 50% in the first five months of 2015.[122] USD exposure is especially high. To mitigate the prospective risks stemming from high corporate-sector debt, further buildup of leverage should be limited and banks' buffers should be improved.

As many of the OIC non-financial corporates earn their revenues (either directly or indirectly) from oil (such as the GCC countries) and/or the commodity markets (such as Malaysia), the fall in oil and commodity prices will have possibly increased their vulnerability. Moreover, in an environment of an appreciating USD and rising Fed interest rates, it will be more difficult for these corporates to repay their liabilities even if USD-denominated commodity and oil revenues were partly to secure a natural hedge.

3.2 ISLAMIC BANKING: ASSESSMENT OF ITS RESILIENCE

It is becoming more crucial for the Islamic banking sector to build long-term resilience and to diversify its revenue pools as the downside risks to the world economy become more pronounced in the wake of weakening commodity prices, a slowing Chinese economy and reduced financial inflows to the emerging markets. Although, on the upside, the decline in oil prices could provide a boost, the pickup in consumption by oil importers has so far been somewhat weaker than evidenced during past episodes of oil price declines, possibly reflecting continued deleveraging in some of these economies.[123] Furthermore, global trade growth has also been marked down for 2016 and 2017, reflecting developments in China[124] and other distressed economies experiencing economic turbulence.[125] Under current economic circumstances, it is even more imperative for policymakers to manage macroeconomics and financial vulnerabilities while instilling measures to spur healthy growth of financial institutions. Banks may become distressed, especially if they operate within limited countercyclical policies and weak regulatory and supervisory frameworks.[126]

In analysing the resilience of the Islamic banking sector, Islamic banks' susceptibility to growth externalities, policy measures and financial market conditions must be observed. This section analyses the resilience of the Islamic banking industry using financial results of 2014 and, where possible, data from the first half of 2015. The assessment draws upon a sample size of 59 banks[127] for

[120] IMF (2015), *Global Financial Stability,* October.
[121] IIF (2015), "Corporate Debt in Emerging Markets", *Capital Markets Monitor Research Note.*
[122] IIF (2015), "Corporate Debt in Emerging Markets", *Capital Markets Monitor Research Note.*
[123] IMF (2016), *World Economic Outlook,* January.
[124] According to the *World Economic Outlook* of January 2016, growth in China is expected to slow to 6.3% in 2016 and to 6.0% in 2017.
[125] IMF (2016), *World Economic Outlook* January.
[126] IMF, October 2015.
[127] The statistics reported in this section are based on a sample of banks' for each country discussed and hence, might differ from those aggregate industry-wide statistics reported by RSAs in their annual reports, for instance. For further details and a list of sample banks, refer to the Islamic Banking Sample Methodology in the Appendix section at the end of this report.

the period of 2014 in 11 Islamic banking markets;[128] the total assets of these sample banks amounted to USD672.2 billion as at 1H2015, which represents 71.6% of the total Islamic banking assets in 1H2015 (if Iran is excluded). This sample will be used as an indicative measure of the overall Islamic banking industry's performance and its trends from 2008 to 2014. Where necessary, this section also provide analyses on how current market conditions may impact future performance of the Islamic banking sector.

Broadly, based on 2014 financial results of the sample banks, the Islamic banking industry has fared well in profitability levels. Financing exposures in market-sensitive sectors (e.g. real estate) are generally contained; nonetheless, working capital financing remains the main source of financing growth for several countries (having more than 60% concentration in working capital financing). Although this is an encouraging trend, it may indicate for some countries their greater susceptibility to the potential economic slowdown in core enterprise sectors. Capitalisation remains resilient and above regulatory requirements. Despite these broad improvements across most indicators at the global level, individual country performances vary.

Table 3.2.1
Selected Islamic Finance Stability Indicators: A Snapshot

Return on Assets		Return on Equity		Net Profit Margin		Cost to Income	
2014	0.95%	2014	8.96%	2014	1.04%	2014	55.88%
2013	0.89%	2013	8.89%	2013	0.96%	2013	55.84%
2014	2.75%	2014	70.50%	2014	16.40%	2014	14.09%
2013	4.12%	2013	81.18%	2013	16.79%	2013	15.23%
Non-Performing Financing		3M Asset Liability Ratio		Total Capital Adequacy		Tier1 Capital Adequacy	

Source: Islamic Banking Sample, IFSB.

The Islamic banking industry's profitability has registered marginal improvements and sustained its cost-to-income level. The average return on assets (ROA) and return on equity (ROE) across the Islamic banking sample[129] were recorded as 0.95% and 8.96%, respectively, in 2014, but have yet to revert to the industry's 2008 pre-crisis (ROA: 1.3%, ROE: 9.9%) levels. A closer look at country-specific performance shows mixed trends. The UAE improved its ROA and ROE to its pre-crisis 2008 rates, whereas Bangladesh and Turkey reached their lowest profitability levels since 2008. Similarly, an improvement in the net profit margin is seen at an aggregate level, with varying directions at the country-specific level. In 2014, the net profit margin increased to 1.04%, from 0.96% in 2013.

Liquidity conditions of the Islamic banking industry have declined from 2013 levels, as measured by the short-term asset–liability ratio (SALR) and the financing-to-deposit ratio (FDR) (explained in section 3.2.2). Across the sample, Islamic banks, on average, had liquid assets to meet 70.50% of the total 90 days' liabilities as of end-2013. As was also the case in 2013, the lowest levels of SALR recorded in 2014 are in Malaysia (43.93%) and Qatar (47.07%). Countries with the highest SALR are Pakistan (138.69%) and Jordan (118.78%). Meanwhile, the average FDR of the Islamic banking sample stood at 92.87% in 2014, an increase from 90.74% in 2013. Consistent with the regulatory limits imposed by GCC countries on their banking institutions, the FDR levels in Saudi Arabia, Kuwait,[130] Bahrain, Qatar and the UAE remain below 100%. However, Indonesia, Malaysia and Turkey appear to be among the group of countries with FDR in excess of 100%.

Islamic banks have remained well capitalised above the regulatory minimum requirements. The average total capital was sustained at 16.40% in 2014, albeit 0.3% lower than in 2013. Total Tier-1 capital adequacy, an indicator that measures capital strength as a percentage of risk-weighted assets, declined to 14.09% in 2014 (2013: 15.23%).

The following subsections assess various indicators across the Islamic banking samples and discuss country-specific forces affecting the performances of the industry.

3.2.1 Profitability

Profitability of the Islamic banking industry witnessed a recovering trend after its decline in 2009. Within the period that ended in December 2014, analysis from the Islamic banking sample[131] displayed continued recovery, where the profitability levels of Islamic banks have improved marginally. Both ROA and ROE improved to 0.95% (2013: 0.89%) and 8.96% (2013: 8.89%), respectively (see Chart 3.2.1.1). Islamic banks fared much better than a sample of 32 global banks, whose ROE stood at 5.8% in 2014, a decline from 7.2% in 2010.[132]

[128] Iran, the largest Islamic banking domicile, is excluded from the analysis due to historical data limitations in the sample banks dataset. Iran's banking sector is now represented by 32 Islamic banks with total assets amounting to USD373 billion as at end-2014.

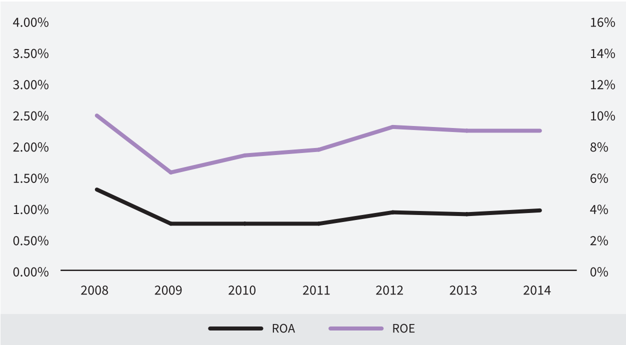
[129] The Islamic banking sample comprises full-fledged and subsidiary banks. The analysis excludes Islamic windows, as there are data limitation issues with regards to Islamic windows in most jurisdictions. Where data on Islamic windows are available, there is an issue of limited financial disclosure of Islamic windows as a separate business. The list of banks is presented in the appendix section at the end of this report.

[130] The Central Bank of Kuwait (CBK) adopted in May 2012 a stable funding ratio requirement as its maximum lending limit. The new requirement stipulates that lending should not exceed 100% of stable funds and replaces CBK`s long-standing loans-to- deposit ratio requirement.

[131] In assessing the resilience indicators of the Islamic banking sample, Turkey's Bank Asya is excluded from the sample for the 2015 data point to avoid misrepresentation of the industry's performance due to data distortion. The bank announced losses of 876.872 million Turkish Liras in 2014 and is undergoing a restructuring and reconsolidation process. Historical data points remain unchanged and included Bank Asya in the sample set.

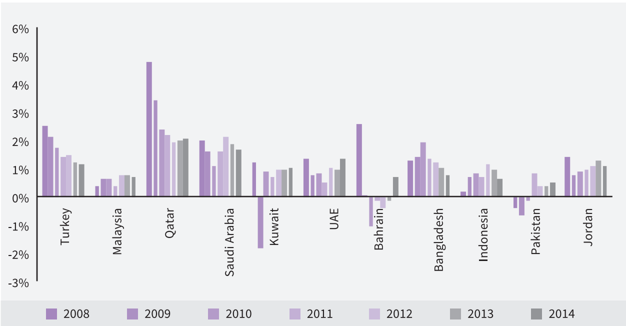
[132] PwC and Capital IQ, *Global Financial Markets Liquidity Study 2015.*

Chart 3.2.1.1
Islamic Banking Average Return on Assets and Equity



Source: Islamic Banking Sample, IFSB.

Chart 3.2.1.2
Islamic Banking Average Return on Assets by Country



Source: Islamic Banking Sample, IFSB.

Although profitability rates improved (based on all sample banks), country-level performances displayed mixed results. Generally, profitability levels in the GCC region improved with the exception of Saudi Arabia. ROA and ROE levels of Saudi Arabian sample banks decreased to 11.83% and 1.64% (2013: 12.75%, 1.84%). A major contributing factor was the new consumer finance rule by the Saudi Arabian Monetary Agency in 2014 capping banks' fees and administrative costs at the lower of 1% of the financing amount or SAR5000 (USD1333). This move by SAMA has had a profound impact on the cost-to-income ratio of a large retail bank in the country, whose net profit shrank almost 19% compared to 2013.

Other GCC markets – namely, Bahrain, Kuwait, Qatar and the UAE – recorded improvements in their ROA level, albeit at different paces. The UAE's ROA has surpassed its 2008 ROA rate of 1.34% to reach 1.35%; however, its ROE is still below the 2008 level. In the past few years, the Bahraini banking system has been stifled by a challenging economic and political environment, thus affecting the sector's profitability. Nevertheless, in 2014, Bahrain bounced back from its four consecutive years of negative profitability ratios, posting ROA and ROE of 0.7% and 4.69%, respectively. The improved funding conditions were a key factor that has accelerated credit demand in the country, largely supported by retail banks that remain the engine for growth of the financial sector[133] in Bahrain. The year also saw rating agencies reaffirm the outlook for Bahrain's retail banking system, changing its rating to stable from negative in March 2014. However, not long after the signals of recovery, Standard & Poor's downgraded the country's sovereign rating from BBB/A-2 to BBB-/A-3 along with Oman's rating in the first quarter of 2015, due to falling oil prices, which will have implications for its 2015 balance sheet.[134]

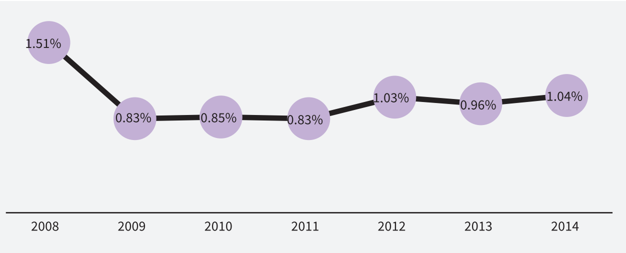
Bangladesh and Turkey witnessed the reverse, due to multiple external market pressures including deterioration of financing quality, squeezed margins and national currency depreciation against the USD. Bangladesh and Turkish Islamic banks were at their lowest ROA and ROE rates since 2008. The Bangladesh sample banks' profitability deteriorated on the back of an increasing level of non-performing financing and the spread of tightening profit rates in its banking sector. However, the Bangladesh sample banks' ROA in 2014 is still higher than the overall Bangladesh banking sector's ROA of 0.9%. According to recent aggregate data[135] published by Bangladesh Bank. Conditions have improved. At the national level, NPF and interest spreads have improved moderately towards the final quarter of 2014 and in the first two quarters of 2015. According to the report, the monthly interest rate spread of all banks (measured by the difference of weighted average interest rate of advances and deposits) increased to 5.21% at the end of 2Q2015 from 5.1% in September 2014. In the case of Turkey, the funding structure of the Turkish banking system, where the foreign exchange liabilities of Turkish banks are constantly increasing, exposes the banks to greater volatility, which would weigh on their profitability.[136] High operating cost also contributes to the decline of profitability rates in Turkey.

Elsewhere, such as in South-East Asia, profitability levels of Indonesia and Malaysia declined, although Indonesia witnessed the more significant drop. Its ROA and ROE dropped to 0.6% and 5.9%, respectively (2013: 0.9%, 11.6%); Malaysia's returns were 0.7% and 8.8%, respectively (2013: 0.8%, 10.5%). The major deterioration of profitability in Indonesia was caused partly by the increase in the provision for financing losses. The rise of NPF has forced major banks to make higher provisions for bad loans, which consequently will affect net

[133] Central Bank of Bahrain (2015), *Financial Stability Report,* February.
[134] Standard & Poor's noted that Bahrain derived about 65% of its fiscal revenue last year from crude oil receipts, which are part of the 84% of total revenue it derives from the oil and gas industry.
[135] *Bangladesh Bank Quarterly Report.*
[136] Moody's (2014), "Turkish banks under pressure for growth, profit", 5 November. As analysed in section 1.6.6, Turkish Islamic banks have the highest exposure in foreign currency deposits, at 27%.

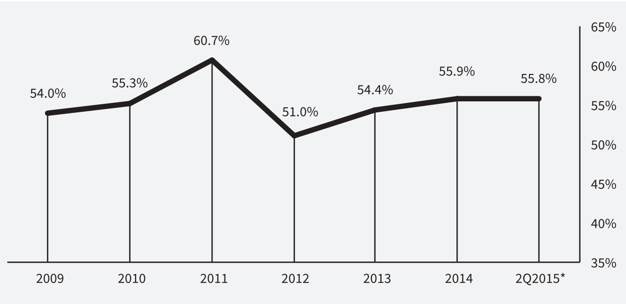
earnings.[137] Economic slowdown and the depreciation of the Rupiah against the USD have also aggravated the situation as a result of weakening purchasing power and consumption.[138]

Chart 3.2.1.3
Islamic Banking Average Net Profit Margin



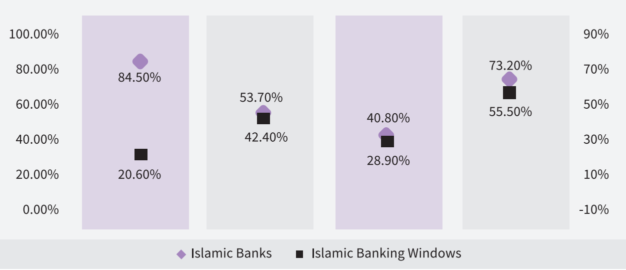
Source: Islamic Banking Sample, IFSB.

Chart 3.2.1.4
Islamic Banking Average Cost to Income



Source: Islamic Banking Sample, IFSB.

Chart 3.2.1.5
Cost to Income (Islamic banking and Islamic banking window)



Source: PSIFI, IFSB

The average net profit margin of sample banks stood at 1.04% in 2014, slightly better than in 2013 (0.96%). A similar trend is observed here. There was a substantial credit earnings improvement in the GCC markets (except for Saudi Arabia); however, a declining net profit margin was seen in the Asian jurisdictions – namely, Bangladesh, Turkey, Malaysia and Indonesia. Tightening profit margins and rising operation costs are fundamental to this, reflected in the cost-to-income ratios of the respective countries. In Asia, Pakistan recorded a net profit margin improvement, as well as a decrease in its cost-to-income ratio.

Increasing cost of banking operations has been one of the factors driving the reduction of net profit in the Asian countries mentioned above. The countries that recorded an increase in the average cost-to-income ratio are Kuwait,[139] Malaysia, Saudi Arabia, Turkey, Bangladesh, Indonesia and Jordan. With the exception of Kuwait, these countries also recorded a decline in their net profit margin. Turkey experienced a significant cost-to-income ratio increase from 66.9% in 2013 to 82.8%[140] for the period that ended in 2014. According to a report,[141] the small and medium-size banks in Turkey have a high cost-to-income ratio among the sector due to their high operating expenses.

A new analysis on cost-to-income comparisons is included this year using the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFI) database.[142] Cost-to-income comparison of the full-fledged Islamic banks and Islamic banking windows set-up indicates that leveraging on conventional banks' institutional presence through a window set-up is more cost effective, albeit at small variances in Saudi Arabia and Malaysia (See Chart 3.2.1.5). Although Singapore Islamic bank is not included in the sample, a case in point, the board of directors of The Islamic Bank of Asia Ltd (IB Asia) in Singapore has agreed to progressively wind down the entity. The reason quoted was that it is unable to achieve economies of scale as a single entity.

[137] *Jakarta Post*, March 2012.
[138] E&Y (2015), "Indonesian banking industry: challenging yet promising", September.
[139] Latest statistics from the Central Bank of Kuwait indicate a slight increase from 2014 (53.1%) to Q2 in 2015 (53.8%).
[140] Bank Asya is excluded from the dataset. However, even if Bank Asya is included, the cost-to-income ratio for Turkey remains high (78%).
[141] Deloitte (2015), "The call for rerouting Turkish banking sector outlook".
[142] Prudential and Structural Islamic Financial Indicators are the first set of internationally comparable measures of the soundness of Islamic banking systems developed by the IFSB, where data from 17 countries is being collected from the central banks and/or banking supervisors.

Box 3.2.1.1 Stability and Resilience of Financial System: Role of Islamic Banking in Bangladesh
By Bangladesh Bank

"The value-driven, speculation-averse risk-sharing features of Islamic finance attribute greater inclusivity and stability supportiveness to it. Islamic banks and financial institutions fared better than conventional ones in the last global financial crisis, which may be a reason why we see niche presence of Islamic financing widening steadily in non-Muslim countries including the advanced Western economies.... With its ethical, inclusivity promoting and stability enhancing attributes, Islamic finance undoubtedly bears promise of playing a major beneficial role in our socioeconomic development." – Governor, Bangladesh Bank (BB).[143]

Overview

Islamic banking has been thriving in the vibrantly growing Bangladesh economy over the last three decades alongside conventional banks. It is an alternative to conventional banking, not a separate component of the financial system. As of the end-September 2015, it comprised 935 branches of 8 Islamic banks, 19 Islamic banking branches of 8 conventional banks, and 25 Islamic banking windows[144] of 7 conventional banks. Islamic banking services are provided by 10.64% of the outlets of the total banking industry (9197 branches of a total 56 banks), whereas the market share of Islamic banking measured by assets is just below 20% of the total banking industry.

Genesis of Islamic Banking in Bangladesh

Islamic banking in Bangladesh started its journey in 1983 with the establishment of the first Islamic bank – Islami Bank Bangladesh Limited. Afterwards, one bank licensed in 1987, two licensed in 1995, two that converted in 2004, one that converted in 2009 and one licensed in 2013 commenced their operations under Islamic Sharī'ah principles. At present, the oldest and largest Islamic bank possesses 40% of total Islamic banks' assets and liabilities, and 7% of total banking sector assets and liabilities. This bank is the second-largest bank of the country in terms of total assets and total deposit base.[145]

Status and Growth

The Islamic banking sector plays a significant role in maintaining the stability of the financial system as well as the economy with a consistent growth, greater profitability and less non-performing assets ratio compared to its conventional counterpart. This sector experiences a stronger capital base with maintained liquidity which ensures a well-equipped part in the financial system to meet various kinds of shocks they are exposed to. Table 1 shows the status and growth of Islamic banking.

In 2014, the investments (loan and advances) of Islamic banks grew by 20.69%, while the overall industry loan growth was 14.25%. Even more strikingly, the liability base grew by 19.52%, mostly due to a huge positive growth in the deposit base of 19.76%, compared with the growth in overall deposit base of the banking industry of 13.45%.

The combined share of Islamic banking was 18.99% of assets, 24.60% of financing (loans and advances), 20.49% of deposits, and 19.13% of liabilities of the overall banking industry as end-December 2014.

143 Keynote address delivered by Dr Atiur Rahman, Governor, Bangladesh Bank at IFSB–BB Seminar on the Prospects and Challenges in Development of Islamic Finance for Bangladesh, held on 23 September 2013 at Hotel Purbani International, Dhaka.
144 An Islamic banking window represents a small Islamic banking outlet within a conventional banking branch of a conventional bank.
145 Bangladesh Bank (2015), *Financial Stability Report 2014,* June.

Table 1 Comparative Status and Growth of Islamic Banking in Bangladesh
(In billion Bangladeshi Taka (BDT))

Particulars	2013			2014			Growth	
	Islamic banking	Overall banking	Percentage	Islamic banking	Overall banking	Percentage	Islamic banking	Overall banking
Total assets	1462.5	8000.2	18.28%	1735.9	9143.0	18.99%	18.69%	14.28%
Total liabilities	1344.7	7321.9	18.37%	1607.2	8401.7	19.13%	19.52%	14.75%
Total deposits	1221.7	6294.3	19.41%	1463.1	7140.6	20.49%	19.76%	13.45%
Total financing (loans and advances)	1099.3	4720.1	23.29%	1326.7	5392.9	24.60%	20.69%	14.25%

Source: Banking Regulation and Policy Department, Financial Stability Department, Bangladesh Bank.

Profitability

During calendar year (CY) 2014, Islamic banks contributed 22.5% of total industry profits. The ratio of profit income to total assets of Islamic banks reached 8.7%, higher than that of the banking sector's ratio of interest income to total assets of 6.9%. On the other hand, the ratio of non-profit income to total assets was only 1.2% as compared with the industry average of 2.8%, representing a lower income from off-balance sheet transactions and service- and fee-based incomes.

Table 2 Comparison of Profitability as of End-December 2014
(In percentage)

Selected income ratios	Islamic banking sector	Overall banking sector
Non-profit (interest) income to total assets	1.2	2.8
Net profit (interest) income to total assets	2.8	1.5
Profit (interest) income to total assets	8.7	6.9
Net profit (interest) margin	3.4	1.8
ROE	11.5	8.1
ROA	0.8	0.7

Source: Bangladesh Bank, Financial Stability Report 2014.

The ROA of Islamic banking was 0.8%, compared with the overall banking industry ROA of 0.7% in CY14, indicating an efficient use of assets by the Sharīʻah-compliant banks compared with conventional banks.

ROE of Islamic banking stands at 11.5%, higher than that of the overall banking industry's ROE of 8.1% in CY14, indicating the higher earnings of Islamic banks compared with their equity position.

Investment–Deposit Ratio

The investment–deposit ratio (IDR) of all Islamic banks is 82.9% as of end-December 2014, slightly lower than the 85.1% recorded at end-December 2013 and somewhat below the maximum recommended level of 90%. Considering the excess liquidity holdings in the Islamic banks, Bangladesh Bank amended the Bangladesh Government Islami Investment Bond (Islamic Bond) Policy, 2004. The objective of the amendment was to develop a sound foundation for the Islamic bond market and to convert excess liquidity into investment through Islamic bonds.

Capital Position of Islamic Banks

Under the Basel II accord, given the minimum capital adequacy ratio of 10%, a total of 7 out of 8 Islamic banks have complied well with the regulatory requirement in calendar year 2014. The remaining bank is currently undergoing a restructuring process under the supervision of Bangladesh Bank.

Stability, Risks and Vulnerabilities of Islamic Banks

Islamic banks are in a better position regarding the impaired investments to total investments ratio (4.9%) and the impaired investments to total equity ratio (49.3%) compared to the overall banking industry (9.7% and 67.7%, respectively), indicating that Islamic banks are more resilient in limiting possible losses from their investments (loans and advances) compared with the overall banking industry.

From the stability point of view, Islamic banks are less vulnerable to risks than conventional banks. They are able to pass shocks on the asset side (Loss in *Mushārakah* a/c) to the investment depositors (*muḍārabah* a/c arrangement). Such arrangements proportionately transfer the credit, market and liquidity risks of their assets with their depositors, and thereby support the shareholders from taking excessive risks compared with conventional banks/counterparts. Indeed, when investment revenues are substantially high, Islamic banks may provide a higher percentage of revenues to depositors as a rate of return in line with market deposit interest rates rather than the full profit due to them. They may use profit equalisation reserves and investment risk reserves to achieve this. The banks may do the opposite in years when investment revenues are low, through reducing their own management (Mudārib) fee share to increase the share of distributions for depositors. This risk-sharing arrangement on the deposit gives additional protection to the banks in addition to their book capital.

Inclusive Growth through Islamic Financing

To foster an inclusive growth, Bangladesh Bank calls upon Islamic banks and Islamic windows of conventional banks in its comprehensive Financial Inclusion campaign from 2012 to pursue vigorous promotion of Islamic micro and SME financing and Corporate Social Responsibilities.

Liquidity Situation and Liquidity Management of Islamic Banks in Bangladesh

Sharī'ah-based banks have been performing well as reflected by the increased market share in terms of assets, financing and deposits compared to their conventional equivalents. However, there are very few instruments that can be used for modulating liquidity of Islamic banks based on Sharī'ah principles. In the absence of any Sharī'ah-based product such as *sukūk*, these banks cannot participate in regular day-to-day repo and reverse repo operations. It is necessary, therefore, to innovate new instruments based on Sharī'ah considering technical and applied aspects for the liquidity management of Islamic banks. The main instrument for liquidity management of Islamic banks is Bangladesh Government Islamic Investment Bond (BGIIB). Changes in reserves requirements – that is cash reserve requirement (CRR) and statutory liquidity ratio (SLR)[146] – are also used for their liquidity management. These bonds are described in more detail below.

At present, the required CRR is 6.5% for all banks (including Sharī'ah-based banks) on a bi-weekly average basis of the average of total demand and time liabilities with a provision of a minimum 6% on a daily basis. The current rate of SLR is 13% for conventional banks and 5.5% for Sharī'ah-based banks, as there is a lack of Sharī'ah-based securities.

It is woth mentioning that the liquidity situation of the banks would be better explained by the excess reserve. Banks invest some parts of their liquidity in approved securities either mandatorily or optionally, which cannot be considered as excess reserves as they get some profit/interest from it. As such, by "excess reserves" we mean cash over CRR held with BB's current account. The excess reserves of banks stood at BDT71.97 billion as of 29 November 2015, which was BDT18.34 billion at end June 2015 (Table 3). The excess reserves of Islamic banks stood at BDT30.10 billion as of 29 November 2015, which was BDT22.16 billion at end June 2015. Of the total excess reserves of the banking system, Islamic banks hold a large share (41.8%, as of 29 November 2015).

[146] This is defined in the Bank Company Act 1991 as the bank's ratio of gold, cash or unencumbered approved securities to its time and demand liabilities.

Table 3 Comparative Position of Excess Reserves of Islamic Banks
(In million taka)

Date	All banks			Excess reserves of conventional banks	Excess reserves of Islamic banks	Share of Islamic banks in total excess reserves (%)
	Total reserves balance held with BB	Required CRR*	Excess reserves over CRR			
	1	2	3	4=(3-5)	5	6=5/3
30-06-08	118,137	109,859	8,278	4,680	3,598	43.5
30-06-09	231,651	132,707	98,944	68,905	30,039	30.4
30-06-10	234,829	176,420	58,409	24,849	33,560	57.5
30-06-11	290,194	251,250	38,944	14,226	24,718	63.5
30-06-12	326,673	295,429	31,244	22,142	9,102	29.1
30-06-13	368,055	338,072	29,983	15,049	14,934	49.8
30-06-14	439,977	423,452	16,525	–212	16,737	101.3
30-06-15	498,389	480,047	18,342	–3,815	22,157	120.8
29-11-15	583,356	511,388	71,967	41,869	30,099	41.8

**Calculated @ 6.5% of total demand and time liabilities adjusted with investment in Islamic securities for the Islamic banks, w.e.f. 24 June 2014.*
Source: Monetary Policy Department, Bangladesh Bank.

Conventional banks have been maintaining their excess liquidity through government Treasury bills and bonds, while the Islamic banks cannot invest their surplus liquidity in these monetary instruments due to their interest-bearing nature. Considering the excess liquidity problems of Islamic banks, the Government of Bangladesh introduced Bangladesh Government Islamic Investment Bonds (BGIIB) in 2004 with the objective of developing a sound foundation for the Islamic bond market and to convert excess liquidity into investment through Islamic bonds. The main features of Islamic investment bonds, according to the Bangladesh Government Islamic Investment Bond (Islamic bond) Rules 2004 (amended 2014), are as follows:

1. Tenure of the bond: Three months or six months.
2. The banks offering banking services under Islamic Sharīʼah participates in the bond auction to meet the statutory liquidity ratio (SLR).
3. The bond is issued under an open auction process based on a profit-sharing ratio (PSR) between the bank and the Islamic bond fund by following the above-mentioned rules.
4. Funds from bond issuance are accumulated under the Islamic bond fund and the fund is invested in banks or (non-banking) financial institutions offering services under Islamic Sharīʼah.
5. There is scope to invest the Islamic bond fund in Sharīʼah-approved (restricted) asset-based projects taken by the government.
6. The auction is called on every Thursday.
7. As of 30 November 2015, investment from the Islamic bond fund was BDT21.30 billion and outstanding was BDT127.58 billion.

However, as the amount of surplus liquidity of most of the Islamic banks is increasing day by day, which affects their net profit and thus increases the cost of funds, it is felt necessary to establish a Sharīʼah-compatible money market and to develop proper Islamic monetary policy instruments to ensure the smooth achievement of monetary policy objectives.

Regulatory Aspects of Islamic Banking Activities

Banking systems, both conventional and Islamic, are operated under the Banking Company Act 1991 and the Companies Act 1994. Islamic banking guidelines have been circulated by Bangladesh Bank in 2009. In addition, Bangladesh Bank examines the reports of the banks’ Sharīʼah councils in order to observe the banks’ Sharīʼah implementation status.

Final Remark

Islamic banks have broadened their activities, focusing on SMEs, microfinance, agriculture, poverty alleviation, entrepreneurship development, financial inclusion, and so on, besides their normal banking activities. Indeed, Islamic banking is proving itself a stable financial sector in Bangladesh and thus has huge potential to become mainstream banking in future.

Overall, the Islamic banking profitability in 2014 remained resilient in the GCC region with a sustained cost-to-income ratio (some jurisdictions witnessed improvements) although the regulatory expectations have heightened and the operating environment is becoming more competitive. Deterioration of profitability rates due to dampening economic growth performance and asset quality deterioration are witnessed in South-East Asia, Bangladesh and Turkey.

As the outlook for oil prices remains sluggish, economic diversification in the MENA region will play a vital function in supporting the credit portfolio expansion of banks. Strategies by Saudi Arabia and the UAE to spur non-hydrocarbon sectors have, to a certain extent, mitigated amplification of vulnerabilities stemming from falling oil prices, while Oman and Bahrain are highly exposed to the risk of economic slowdown due to their dependency on hydrocarbon revenues. Private-sector outlays in Malaysia are expected to continue, particularly in the manufacturing and services sectors. However, oil and gas sector revenue and export performance will be key concerns in 2016. In Indonesia, private consumption and industrial sectors will be the key driver. Considering Indonesia is a key commodity-exporting country, China's economic slowdown and Asia's moderate growth will likely have a profound impact on its export growth.

3.2.2 Liquidity

Liquidity management remains a concern in most jurisdictions. Based on the CIBAFI Global Islamic Bankers' Survey entitled "Risk Perception, Growth Drivers, and Beyond",[147] liquidity risk is highlighted as a primary concern in South-East Asia, North Africa and Sub-Saharan Africa. On the other hand, GCC Islamic banks did not identify liquidity risk management as one of their highest concerns, given the strong liquidity positions of most banks in the region. Nevertheless, development of a resilient liquidity position and improvement in market liquidity of Islamic financial markets are priorities of almost all Islamic financial markets, including the GCC.

In understanding the global liquidity positions outlook, a study by PwC[148] analyses and suggests a potential reduction in market liquidity echoed by four areas of weakness, namely: (a) difficulty of executing trades; (b) reduction in market depth; (c) increase in volatility; and (d) bifurcation in liquidity – that is, a reduction in liquidity in assets which have traditionally been less liquid. Anecdotal evidence shared in the study included increased volatility in bond markets, which in 2015 is around 40% higher than in 2014. In addition, although the fixed-income markets have grown significantly in size (almost doubling in the EU and increasing by 50% in the US since 2007), trading volumes have not kept pace with the growth in issuance. For instance, European corporate bond trading volumes have declined by 45% between 2010 and 2015.[149] Data from the Asian Development Bank also shows that average transaction sizes in corporate bonds for a sample of Asian countries fell from 2010 to 2013. These analyses share a critical perspective of how future liquidity conditions will be more constrained, while liquidity risks have generally risen. To this end, the IFSI must accelerate the development of robust Islamic liquidity asset classes to enhance the position of Islamic financial institutions. Islamic banks continued to face a general lack of tradable Sharī'ah-compliant instruments that can serve as high-quality, short-term liquid assets, a critical challenge in preparing to meet Basel III's liquidity coverage ratio and net stable funding ratio (NSFR) requirements.

The liquidity conditions of Islamic banks have worsened, with increasing financing-to-deposit ratios (FDRs)[150] and lower short-term asset–liability ratios (SALRs),[151] but the deteriorations are not alarming. Although FDR also depends on banks' choices in the context of their liquidity management, the ratio may provide an indication that deposits in the banks are mobilised for productive financing growth, which may contribute to higher earnings. For instance, in the case of the United States' commercial banking industry, Federal Reserve data showed that the loan-to-deposit ratio was in excess of 100% prior to the 2008 crisis. In the current low interest rate environment, as lucrative investments are drying up,

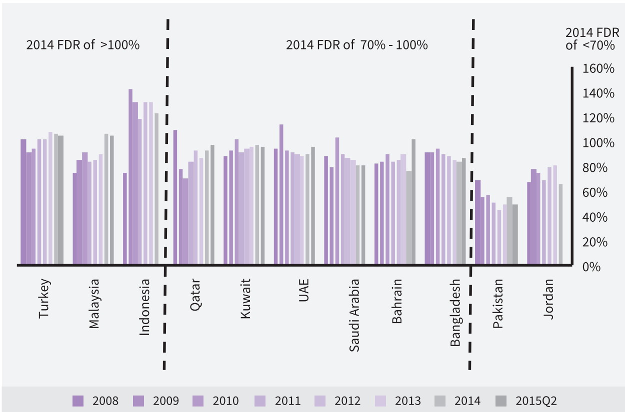
[147] This inaugural industry survey reflects the views of 83 heads of Islamic banks from 35 countries.
[148] *Global Financial Markets Liquidity Study 2015 Report.*
[149] *Global Financial Markets Liquidity Study 2015 Report.*
[150] FDR is a widely used ratio that assesses the ability of financial institutions to support unforeseen needs of banks. The use of the term "deposit" in this section includes UPSIAs, which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.
[151] As disclosed in the annual reports of Islamic banks, the SALR measures the amount of highly liquid assets held by financial institutions in order to meet short-term obligations payable within a period of 90 days. The analysis in this section, however, does not address liquidity from the perspectives of the Basel III LCR.

deposits in the US are growing faster than loans. In the second quarter of 2015, the loan-to-deposit ratio stood at only 77%.[152] Arguably, there is no ideal FDR position, and it is subject to regulatory expectations and limits based on prevailing market conditions. However, FDR of 80–90% is considered a comfortable position. The SALR, on the other hand, assesses the short-term liquidity risk of Islamic banks by measuring their ability to pay off their short-term liabilities with current assets. In managing their liquidity position, Islamic banks are faced with issues of limited access to active interbank Islamic money markets, as well as the unavailability of highly tradable papers. They tend to hold larger amounts of cash due to their limited use of short-term tradable instruments. In addition, it is observed that issuances of *sukūk* with a tenor of less than one year in 2014 dropped more than 50% as compared to 2013 short-term *sukūk* issued. A major factor in this change was Bank Negara Malaysia's pullback from offering short-term *sukūk*.

Country-specific analysis of the FDR of sample banks can be broadly categorised into three groups. Indonesia, Malaysia and Turkey appear to be in the group of countries with FDRs in excess of 100% in 2014 (see Chart 3.2.2.1). Malaysia for a number of years remained below 100%, but this year its FDR was 106.6%, based on the sample banks. Indonesia's FDR has increased steadily since 2011 (118%), and in 2014 its sample banks recorded a decrease in the FDR (121.84%) – still the highest rate in all the sample countries. Such a high FDR exposes Indonesian Islamic banks to a comparatively higher risk of illiquidity given their greater reliance on funds markets to raise liquidity in order to support their portfolio of financing assets. A market report also indicates that banks in Indonesia were actively shoring up liquidity in the first half of 2014 with higher interbank placements with the central bank and liquid assets in secondary reserves.[153] Turkish participation banks' FDR decreased from about 107.1% in 2013 to 105% in 2014, when the financing growth rate was affected by macroprudential measures. Financing growth started to pick up in Turkey in the first half of 2015, with the result that the FDR increased to 115% [154] in the second quarter of 2015.[155]

FDR across the GCC countries' sample banks hovered at around 70–100%, reflecting the limits placed on loan-to-deposit ratios from time to time by those countries' central banks. The most recent instance was in 2015, when the Qatar Central Bank announced that commercial banks' loan-to-deposit ratio should not exceed 100%. In Bangladesh, FDR (also known as the investment–deposit ratio) has remained in the range of 80–90% since 2012, still below the maximum recommended level of 90%.[156] In the second quarter of 2015, it stood at 86%. In comparison, the conventional banks' FDR (known as advances-to-deposit ratio) in Bangladesh was well below the maximum allowable limit throughout the year, which is not desirable for stimulating economic growth.[157] Chart 3.2.2.1 shows that only Jordan and Pakistan have FDRs lower than 70%. Consistent with the IFSB Financial Stability Report 2015, Pakistan continued to experience low FDR ranges of between 42% and 55% between 2009 and 2014.

Chart 3.2.2.1
Islamic Banking Average Total Financing to Deposits



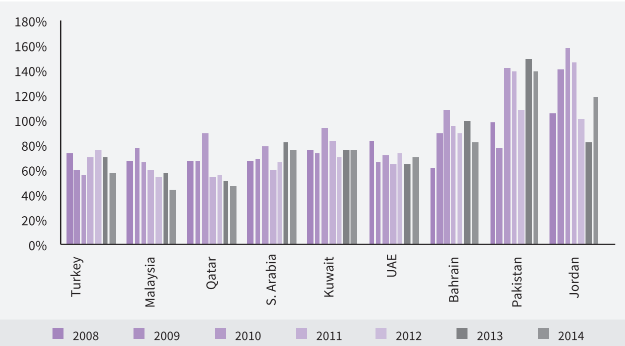
Source: Islamic Banking Sample, IFSB.

Across the sample, Islamic banks on average had liquid assets to meet 71.32% of the total 90 days' liabilities as at end-2014, a significant drop from last year's SALR of 81.8%. Consistent with the previous year's trend, Malaysia (43.9%), Qatar (47.1%) and Turkey (57.1%) recorded the lowest SALRs. In an environment where banks have access to liquid and interbank money markets, low levels of SALR may not be alarming as long as risk management measures are put in place.[158] However, for markets with no active Sharīʻah-compliant interbank arrangements and no secondary market for *sukūk* trading, a low level of SALR may signal a higher liquidity risk. However, further examination is required to see the structure and composition of assets and liabilities of the bank to understand its potential risky positions. Pakistan is the only country that registered an SALR of over 100%, as Islamic banks in that country mobilised funds in government Treasury papers that are tradable in the secondary market. Sustainable reissuances of *sukūk* upon maturity by governments will enable Islamic banks to invest their excess cash sustainably. This is especially appropriate for Pakistan, where the FDR is low and deposits grew at a faster rate than financing growth.

152 "Loan-to-Deposit Ratio", *U.S. Banking Review,* Q2 2015.
153 DBS Group Research (2014), *Indonesia Country Focus,* September.
154 The Turkish conventional banking sector had a loan-to-deposit ratio of 116% as at the second quarter of 2015.
155 Turkish Banks Association (2015), *Banking System in Turkey Report,* June.
156 Sharīʻah banks' limit for the investment-to-deposit ratio is 90%; however, for conventional banks, the advances-to-deposit ratio is 85%.
157 *Bangladesh Bank Financial Stability Report 2014–June 2015.*
158 The Malaysian central bank also operates a Sharīʻah-compliant liquidity programme while being available as a lender of last resort should the need arise in any Islamic bank.

Overall, SALR and FDR are simple indicators to reflect the actual liquidity positions of the Islamic banks. However, Islamic banks manage liquidity through various funding sources in addition to deposits/PSIA (e.g. *sukūk*, alternative to repo), and are also currently striving to maintain larger stock of high-quality liquid assets based on the LCR parameter to meet the phased implementation timeline of the BCBS.

Chart 3.2.2.2
Islamic Banking Short-term Asset–Liability Ratio[159]



Source: Islamic Banking Sample, IFSB.

Recognising the challenges, efforts are being pursued at both the national and global levels. At the global level, the International Islamic Liquidity Management Corporation[160] continued its short-term *sukūk* programme which is backed by sovereign assets of its shareholders. *Sukūk* by IILM is rated as A-1 by Standard & Poor's, and IILM has the first multi-jurisdictional primary dealer network that facilitates distribution to investors worldwide. As at November 2015, total issuance of IILM *sukūk* was worth USD13.18 billion.[161]

At the country level, Bahrain's central bank launched one-week *wakālah* contracts, a new liquidity management tool offered to Islamic retail banks,[162] a new liquidity management tool offered to Islamic retail banks.[163] In the UAE, Islamic banks will benefit from the central bank's decision this year to include Sharī'ah-compliant securities in the range of instruments accepted as collateral for banks' liquidity pool. Another positive development was the introduction of the process of auctioning Islamic bonds starting from January 2015 by Bangladesh Bank.

Banks are especially vulnerable to liquidity risk due to their role in the maturity transformation of short-term deposits into long-term loans. Looking forward, 2016 will be a challenging year for Islamic banks from a liquidity perspective. In 2015, *sukūk* issuances recorded only about 50% of the 2013 amount. Furthermore, there is a potential reduction in market liquidity at times when banks are in the process of complying with the liquidity requirements of Basel III.

3.2.3 Financing Exposures

Based on the sample banks, broken down by country, the Islamic banking industry's business financing exposure is concentrated in the household and private sectors (see Chart 3.2.3.1).

Chart 3.2.3.1
Islamic Banking Average Composition of Financing Exposures[164] **(2014)**

Source: Islamic Banking Sample, IFSB.
Note: Financing exposures are based on the reporting structure of Islamic banks, with variation of categorisation expected. In particular, the fact that some jurisdictions report zero exposure to the real estate sector suggests that this exposure may be aggregated with another category.

Periodic reviews of risk management and capital management processes for large exposures and risk concentrations[165] are necessary to measure any substantial concentration risk that will trigger financial instability. An exposure concentration of financing portfolios generally increases the associated credit risk. Although banks are designed to spur economic growth through effective mobilisation of funds, this process needs to be undertaken through a robust assessment process with a clear understanding of the risks involved in order to act in the best interests of the depositors, account holders and shareholders.

Based on historical and recent data as at end-2014, several trends are observed and analysed below:

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[159] The chart excludes Bangladesh and Indonesia, where relevant data are not available across all the years.
[160] IILM is a global multilateral entity established by a group of central banks, monetary authorities and a multilateral organisation to create and issue short-term Sharī'ah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.
[161] IILM Press Release, 19 November 2015.
[162] Central Bank of Bahrain.
[163] Prior to this, Islamic banks in Bahrain managed their liquidity using the central bank's monthly issues of 91- and 182-day *sukūk*.
[164] Classifications as disclosed in the financial statements of individual banks. In general, household exposure includes all forms of financing to individuals in addition to personal financing – for example, car financing. Government exposures include financing to government-related entities. Real estate exposures include direct holdings of property and investments in property companies and may also include individuals' home financing. "Private sector" includes all financing extended towards business enterprises.
[165] "Risk concentration" is defined as "any single exposure or group of similar exposures (e.g. to the same counterparty, including protection providers, geographic area, industry or other risk factors) with the potential to produce (i) losses large enough (relative to an IIFS's earnings, capital, total assets or overall risk level) to threaten an IIFS's creditworthiness or ability to maintain its core operations or (ii) a material change in an IIFS's risk profile" (IFSB-16).

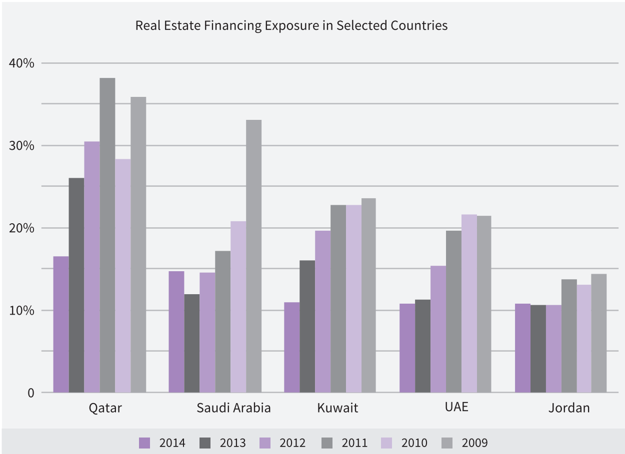
- Bangladesh[166] sample banks indicate corporate credit as the main sources of growth. Other countries with a similar trend are Kuwait (70%), Pakistan (63%) and Bahrain (60%). This trend is expected to continue, as the survey findings by CIBAFI[167] show that Islamic banks believe business lines such as business finance, real estate and project finance will continue to be the main drivers of revenues for Islamic banks. These markets are vulnerable to financial market conditions and economic growth. Economic downturns or the rising interest rate environment could potentially increase balance sheet pressure of businesses. Long-term structural changes in an economy may also impact borrowers' ability to service their financing. For instance, in Bahrain, the construction, trade and manufacturing sectors recorded their highest impairment levels in September 2014.[168]

- Jordan sample banks have the highest financing composition in the government sector, followed by the Qatar sample banks. This trend is consistent with their conventional banking sector profile, where the government sector represents a significant portion of the loans amount disbursed. Qatar, as an oil-exporting country, announced plans to take measures to rationalise expenditure on the fiscal side in December 2015,[169] and this may have an impact on Qatari banks in the 2016 results. Banks in Qatar may also face deposit pressures, as lower oil prices reduce the flow of funds from the government and government-related entities.[170]

- As analysed in the previous *IFSB IFSI Stability Report,* for countries with a vibrant corporate *sukūk* market, financing concentration inclines towards the households sector, rather than the private sector. This is apparent in Saudi Arabia, Malaysia and the UAE. The Malaysian sample banks have an average exposure of 48.4% in the households sector. Notably, the exposure has shrunk from 53% in 2013, following the introduction of new rules[171] by the Malaysian central bank in mid-2013 to curb the rising household debt.

- Real estate exposure remains on the downward trend since 2009. In 2014, the four countries that have a high real estate[172] balance sheet exposure – namely, Qatar, Saudi Arabia, Kuwait and the UAE – have gradually scaled down their exposures since the 2008 crisis (see Chart 3.2.3.2). In the UAE, bank lending is shifting towards completed properties to avoid fluctuations in the residential market.[173] However, in Jordan, exposure in the real estate sector remains unchanged. There, the real estate market is a booming sector, with real estate sales surging by 15% in 2013 to record revenues of JD5.6 billion (USD7.9 billion). Notably, nearly 90% of the housing units were purchased by Jordanians,[174] thus protecting the market from risks of foreign buyers' flight to quality. In Qatar, real estate prices reached record highs in June 2014, with the average prices of land, commercial and residential properties up 20% on the previous peak of September 2008.[175]

Chart 3.2.3.2
Real Estate Financing Exposure in Selected Countries



Source: Islamic Banking Sample, IFSB.

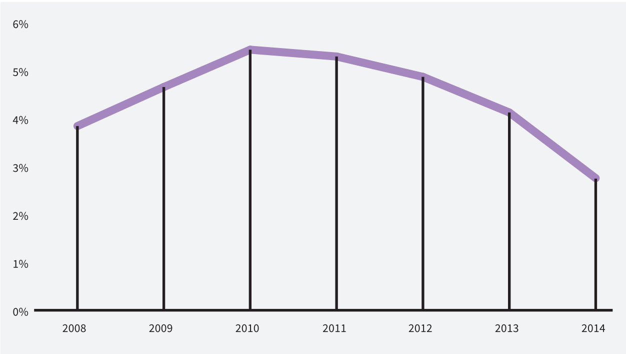
3.2.4 Asset Quality

The asset quality of Islamic banks has improved significantly in 2014 with the average gross NPF ratio of the sample recorded at 2.8% in 2014, healthier than the pre-crisis level of 3.85% in 2008 (see Chart 3.2.4.1). With the exception of Bangladesh and Bahrain, NPFs of the remaining jurisdictions[176] were restored to their pre-crisis levels (see Chart 3.2.4.2). Bahrain also registered an improvement in 2014 with an NPF of 7.72% (2013: 9.23%), though it is yet to reach its 2008 level of 6.72%. Bangladesh is the only country with a rising risk of asset quality in 2014, as its NPF increased to 5.02%, the highest level during the sample period of 2008–2014. Nonetheless, according to a Bangladesh central bank report, the total NPL ratio of

[167] CIBAFI Global Islamic Bankers' Survey on "Risk Perception, Growth Drivers, and Beyond 2015".
[168] Central Bank of Bahrain.
[169] "Qatar halves GDP forecast for 2015 amid oil plunge", *Reuters,* 16 December 2015.
[170] *Moody's Investors Service's Outlook,* July 2015.
[171] Among others, the new measures include reducing the maximum tenure for personal loans to ten years, restricting home loans to no more than 35 years, and prohibiting offers for pre-approved personal loans.
[172] Includes personal home financing.
[173] Central Bank of UAE, *Financial Stability Report 2014.*
[174] Department of Land and Survey, Jordan, January 2014.
[175] Real Estate Price Index (REPI), published by the Qatar Central Bank.
[176] In the case of Turkey, significant improvement was due to the exclusion of Bank Asya from the date set. However, if Bank Asya is included, the NPF is still on a healthier trend of 2.87% (2013: 3.12%).

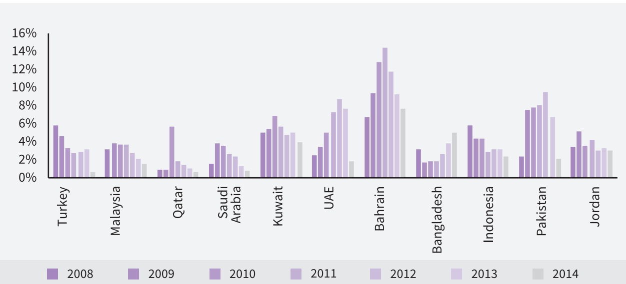
the total Islamic banking industry (4.5%) is still lower than the overall banking industry in Bangladesh (9.7%). *mushārakah* and *muḍārabah* arrangements are cited as factors contributing to the better NPF level of Islamic banks than conventional banks, as Islamic banks are not expected to bear the risks entirely. Nonetheless, looking forward, the oil prices slump will affect the oil-exporting country's fiscal spending, which may also have an impact on household and private consumption as a whole.

Chart 3.2.4.1
Islamic Banking Average Gross Non-performing Financing to Total Financing



Source: Islamic Banking Sample, IFSB.

Chart 3.2.4.2
Islamic Banking Average Gross Non-performing Financing to Total Financing by Country



Source: Islamic Banking Sample, IFSB.

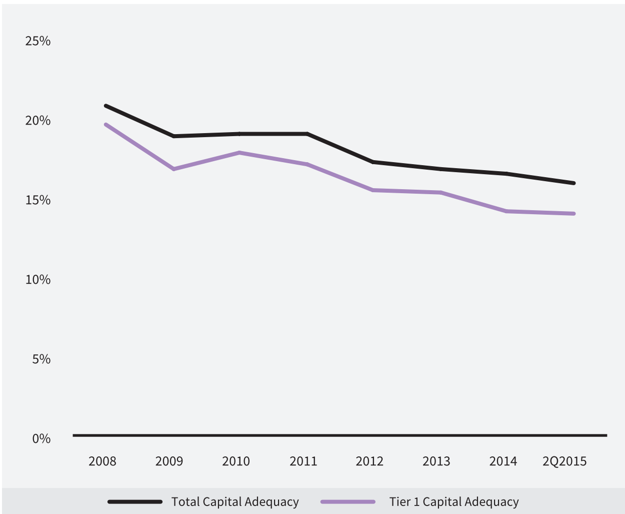
Asset quality in the GCC has improved with the stabilisation of real estate markets, selective financing approvals by the banks (e.g. for property under construction) and the support of new non-oil growth areas. However, despite the improvement across all GCC countries, the NPF ratio of the Bahrain sample banks is still high compared to other peer countries. According to a Central Bank of Bahrain report, analysis by sector indicates that the construction sector accounts for the highest impairment in September 2014, followed by trade and manufacturing. The rating downgrade by S&P due to the oil prices slump may have continued implications for Bahrain's NPF level. Shrinking oil revenue and weakened government spending will dampen banks' operating prospects and may increase their debt accumulation, thus affecting their NPF ratios.

Elsewhere, Malaysia and Turkey have maintained their NPF levels below 4% since 2010. The Pakistani banks sample recorded a significant improvement in its 2014 NPF, recording only 2.11% compared to its 2013 level of 6.68%, where it remained lower than the overall industry ratios, reflecting the relatively better asset quality of Islamic banks. Indonesia has also improved its NPF ratio to 2.32%, from 3.13% in 2013. As the Rupiah remains under pressure and a potential slowdown is anticipated, the key impact of slowing economic growth would be in the form of deteriorating asset quality.[177]

3.2.5 Capitalisation [178]

The average total capital and Tier-1 capital adequacy across the Islamic banking sample stood at 15.79% and 13.89%, respectively (see Chart 3.2.5.1), still above the capitalisation levels imposed by the respective national regulators. The average adequacy ratio was above 20% in 2008, since when it has been declining. This year's levels are the lowest point for both in the sample period. However, the fact that regulators will have been implementing more demanding capital requirements over the period, reflecting changes in international standards, may mean that a reduction in the ratio does not imply that banks are in reality holding less capital. The reduction may also be a signal of improvement in the efficient use of capital to expand the financing portfolio and increase the availability of LOLR facilities.

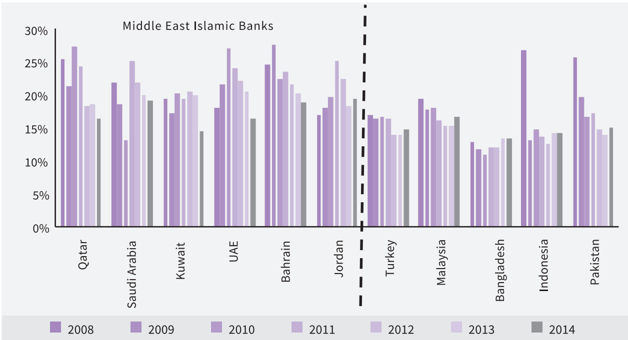
Chart 3.2.5.1
Islamic Banking Average Capital Adequacy Ratios[179]



Source: Islamic Banking Sample, IFSB.

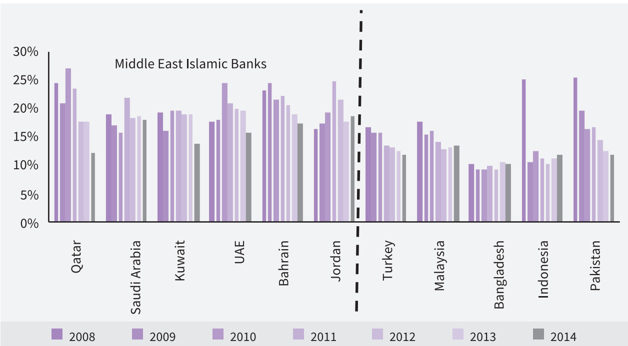
[177] *Moody's Global Credit Research*, June 2015.
[178] The global financial industry is currently in the process of adopting Basel III regulations. As such, the revised regulations notably have an impact on financial institutions' capitalisation. It is important to note that this section is based on financial disclosures of banks to assess capitalisation trends since 2008.
[179] The CARs are not adjusted as per Basel III standards and are taken as reported in the financial statements of Islamic banks.

Chart 3.2.5.2 Islamic Banking Average Total Capital Adequacy Ratio by Country



Source: Islamic Banking Sample, IFSB

Chart 3.2.5.3
Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country



Source: Islamic Banking Sample, IFSB

Analysing individual countries, the GCC banks had the highest regulatory capital levels across the sample, above and beyond the regulatory capital requirements set by domestic financial regulatory bodies. However, consistent with the general overall banking trend in the GCC, individual country average capitalisation is also on a declining trend.[180] The decline in capitalisation levels is also due, in part, to the absorption of losses accumulated in these sample banks. Furthermore, regulatory adjustments to capital following the implementation of Basel III have also contributed towards this decline in capital ratios – for instance, in Kuwait. In early February 2014, the Central Bank of Kuwait (CBK) announced its Basel III implementation over a period of five years, with full implementation to take place by 1 January 2019. Similarly, other GCC countries witnessed drops in their capitalisation ratios. Jordan also posted a high capitalisation level of 19.43% in 2014, up from its 2013 level of 18.20%.

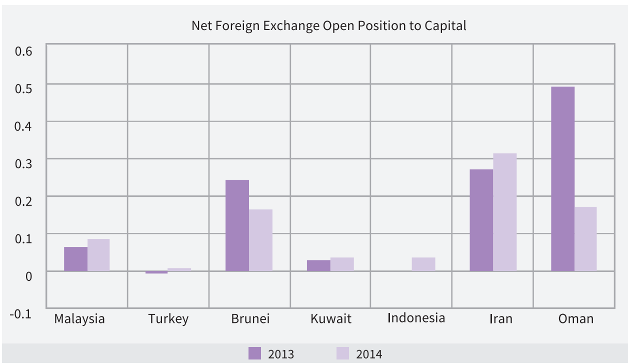
An increasing level of capitalisation is observed in other regions' sample banks, such as in Malaysia, Turkey, Jordan, Pakistan and Indonesia, where average total capital has improved from its 2013 percentage, albeit not significantly. The capital levels of the Islamic banking industry in Pakistani and Indonesian banks witnessed deterioration, reflecting the adverse performance of the banking sector in general. The average total CAR for Pakistan and Indonesia has dropped to 14.31% and 14.98%, respectively, in 2014, much lower than their 2008 levels (Pakistan: 25.61%, Indonesia: 14.31%). Similarly, their Tier-1 total CARs fell to 11.87% and 11.77%, respectively, in 2014, a significant reduction from their initial 2008 levels in excess of 25%.

Overall, Islamic banking capitalisation remains resilient despite a clear deterioration trend in the GCC countries. Given rising global economic challenges, Islamic banks in the GCC region are likely to face slower growth, especially in Bahrain and Oman, due to limited diversification of the region's economic structure. As such, capitalisation levels are expected to further deteriorate, with the possibility of banks registering lower earnings compared to 2014 improved performances.

3.2.6 Structure of Funding

Both conventional and Islamic banks are susceptible to adverse price movements, such as benchmark rates, foreign exchange rates and equity prices. Exchange rate depreciations pose risks to banks, such as reduced ability to repay mobilised foreign currency deposits particularly during an economic crisis or slowdown. Furthermore, exposure to foreign currency deposits may impact the profitability level of banks – especially in emerging markets, which tend to have higher currency volatilities. For the sample banks dataset, disclosures on foreign currency deposits are only available for five countries – namely, Turkey, Saudi Arabia, the UAE, Pakistan and Jordan. In 2014, the average share of Islamic banking deposits in foreign currency was only 2.68%.

Chart 3.2.6.1
Islamic Banking Average Foreign Currency Deposit Share to Total Deposits[181]



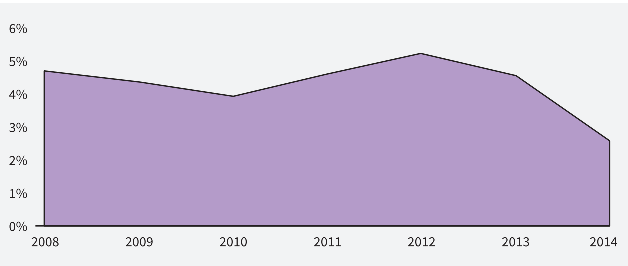
Source: Islamic Banking Sample, IFSB.

[180] However, see the earlier point about more demanding capital standards.
[181] Foreign currency deposits data are only available for five sample countries – namely, Turkey, Saudi Arabia, the United Arab Emirates, Pakistan and Jordan.

The Turkish Islamic banking sample collectively held about 27% of their deposits in foreign currency, down from the 43.42% recorded in 2008. This significant share of foreign currency poses additional risk to the Turkish banking system with heightening volatilities[182] of the Turkish national currency. According to Moody's,[183] Turkish banks may slow their lending growth in 2015–2016, as foreign currency funding will likely become more expensive. Furthermore, most of the foreign currency funding in Turkey is short-term in nature, which could result in higher costs of refinancing. In Jordan, the foreign currency deposits share has reduced from 16.44% in 2013 to 12.89% for the financial year 2014.

A country's net foreign exchange open position to capital (NFEOPC) is calculated in order to monitor foreign exchange risk arising from its business activities. Generally, hedged positions or items that have been included in the calculation of own funds are excluded from the calculation. The regulator will impose its prudential requirements for this net position. For example, in IFSB-15, the capital charge for foreign exchange risk is 8% on the overall net foreign currency position of an IIFS, and this is multiplied by 12.5% to derive the market risk-weighted assets. Chart 3.2.6.2 shows the NFEOPC level derived from the PSIFI database for the years 2013 and 2014. Malaysia, Kuwait and Indonesia witnessed an increase in NFEOPC, while Brunei's level dropped in 2014. From a negative position, Turkey stood at 1.1% in 2014.

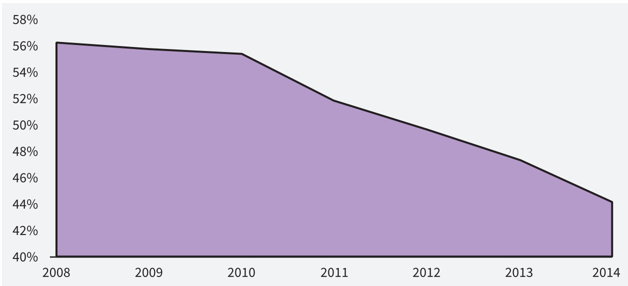
Chart 3.2.6.2
Net Foreign Exchange Open Position to Capital



Source: PSIFI, IFSB

The profit-sharing investment account[184] is a unique funding structure available to Islamic banks that mobilises deposits with returns linked to actual performance of underlying investments. However, the PSIA share has been on a declining trend since 2008. Some banks are now inclined towards alternative sale-based fixed profit deposit products (e.g. Commodity *murābaḥah* term deposits) to be able to meet the demand for capital and profit-guaranteed term deposit solutions. As of 2014, the PSIA share has slipped to 44.11% (see Chart 3.2.6.3). In 2008, it was above 50%. As analysed in the IFSB IFSI Stability Report 2015, the biggest drop in composition of PSIA is witnessed in Malaysia, where the Islamic Financial Services Act 2013 prohibits Islamic banks from adding any facilities that would smooth the returns of the IAHs, thereby removing the "deposit protection" extended to these types of deposits.[185] PSIA share in Malaysia dropped from 40.87% in 2013 to 23.48% in 2014. The preliminary financial highlights of Malaysian sample banks in the second quarter of 2015 indicate that the PSIA share has declined further, to 12.95%. However, the Malaysian central bank has now issued the Investment Account Framework to facilitate the orderly development and operationalisation of investment accounts as a new Sharīʻah-compliant asset class and source of funding. Like Malaysia, the UAE's PSIA share is also on a declining trend. From more than 70% in 2008, it shrank to 50.28% in 2013 and 42.59% in 2014.

Chart 3.2.6.3
Average Profit-sharing Investment Accounts Share to Total Deposits[186]



Source: Islamic Banking Sample, IFSB.

Efforts are being pursued by central banks to place greater emphasis on consumer protection regulations and financial safety nets for Islamic retail customers, as part of the process of providing an enabling framework to spur the growth of investment account deposits.

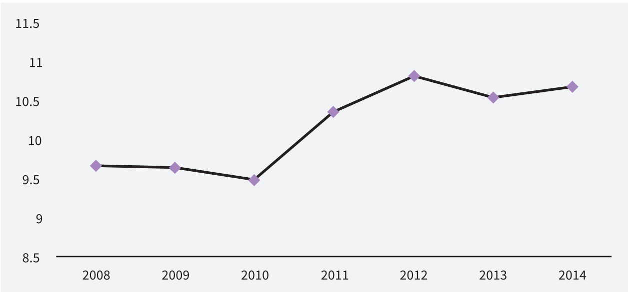
3.2.7 Leverage

Debt limit prevents damage to the financial system and management of the potential build-up of leverage that might have financial instability implications for the domestic and global financial systems. The leverage ratio sets capital that should be held as a percentage of assets on a bank's balance sheet. As such, it indicates the reliance of banks on debt. Islamic banks have maintained modest levels of leverage exposure over the years, reaching an average of 10.68%[187] as at end-2014 (see Chart 3.2.7.1). The individual country level shows a similar sustained trend over the past few years; however, Pakistan has a relatively higher level (15.58%) than the other sample countries.

[182] The Turkish Lira has depreciated by 23% vis-à-vis the USD since end-2014.
[183] Global Credit Research, 1 October 2015.
[184] PSIA in this analysis includes saving and term deposits that are based on profit-sharing principles (i.e. *muḍārabah*).
[185] This came fully into force starting 30 June 2015.
[186] Excluding Kuwait and Indonesia, where data are not sufficiently available across all sample years.
[187] As a comparative indicator, the average US G-SIBs and non-US G-SIBs had leverage multiples of 14.75 and 19.81 times, respectively, in the 1H2013.

The GCC Islamic banks and Bangladesh had the lowest levels of balance sheet leverage multiples[188] (see Chart 3.2.7.2). This indicates the higher levels of equity capital held by Islamic banks in the GCC, which, while promoting greater financial stability, may be less efficient in terms of optimal utilisation of capital. The higher levels of balance sheet leverage multiples were recorded in Pakistan (15.7 times) and Malaysia (13.5 times). In the case of Pakistan, given the increased asset exposure in securities markets for Islamic banks, the financial instability risks are tied to the performance of the capital market, including the performance of government securities and sovereign risk events. In Malaysia, the availability of the LOLR facility from the central bank and an active Islamic capital and interbank money market reduces the risk of Malaysian Islamic banks running out of liquid funds in times of distress.

Chart 3.2.7.1
Islamic Banking Average Bank Balance Sheet Leverage Multiples



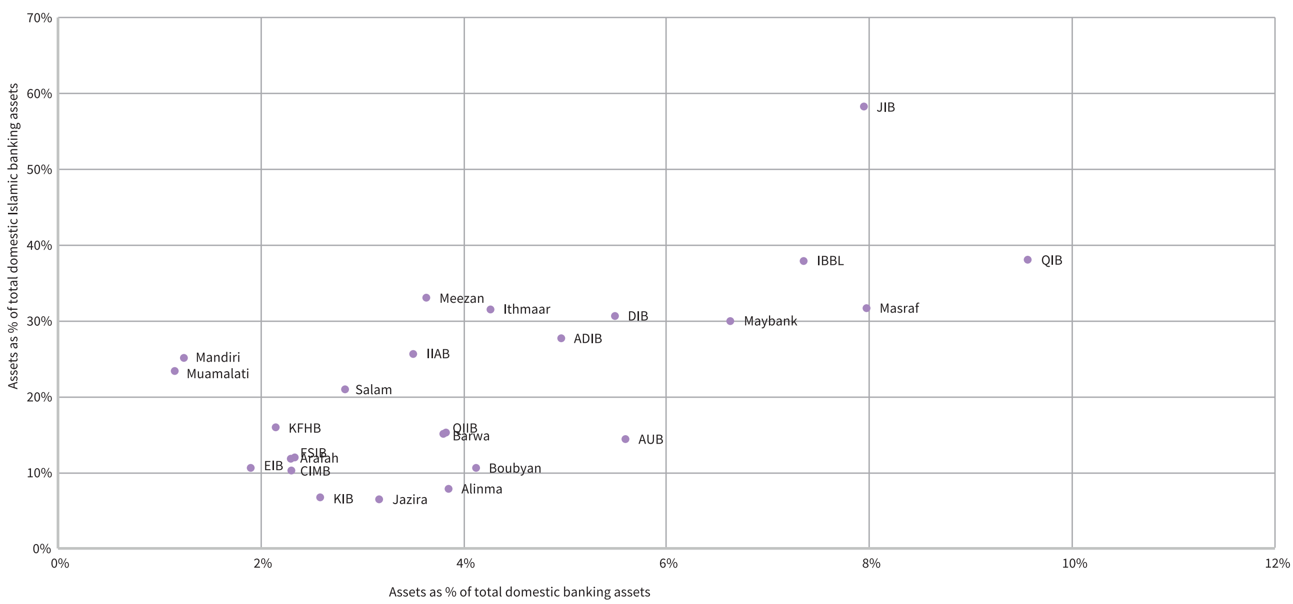
Source: Islamic Banking Sample, IFSB.

Chart 3.2.7.2
Islamic Banking Average Leverage Multiples by Country

Source: Islamic Banking Sample, IFSB.

As per IFSB-17,[189] an effective system of banking supervision requires the supervisory authority to develop and maintain a forward-looking assessment of the risk profile of individual IIFS and banking groups, proportionate to their systemic importance. At present, none of the 59 sample Islamic banks falls under the G-SIBs category of BCBS, although at least 31 of these banks satisfy the domestic systemically important bank criteria[190] used in this report (see Chart 3.2.7.3). The two largest Islamic banks (Al Rajhi and Kuwait Finance House) by total asset size (outside Iran) carry a share of total domestic banking assets of 14.78% and 26%, respectively. The two largest banks in terms of total domestic Islamic banking share are Kuwait Finance House (66.6%) (in Kuwait) and Jordan Islamic Bank (58.21%) (in Jordan).

Chart 3.2.7.3
Sample of Potential Domestic Systemically Important Banks*



Assets as a % of total domestic banking assets
**Sample of Islamic banks with assets >3% of total domestic banking assets (2014) and/or >10% of total domestic Islamic banking assets (2014).*
Source: Islamic Banking Sample, IFSB.

188 Leverage multiple = total assets / total equity. This is not the same as the leverage ratio defined by the BCBS.
189 IFSB-17: Core Principles for Islamic Finance Regulation (Banking segment).
190 Using the criteria of Islamic banks with assets >3% of total domestic banking assets (2013) and/or >10% of total domestic Islamic banking assets (2013).

Overall, Islamic banks have witnessed commendable performance in 2014; however, looking ahead, they will face multidimensional challenges arising from the persistent drop in oil prices and continued vulnerabilities in many emerging markets. In the long run, financial institutions require a delicate balance between continued sophistication, aligning to global regulation and compliance, while ensuring that the needs of bottom-line businesses are met through effective operating and cost-competitive business strategies.

3.3 *TAKĀFUL*: ASSESSMENT OF ITS RESILIENCE

The *takāful* market has been a developing area of interest for regulators and policymakers concerned with financial stability in the countries in which the *takāful* industry has been thriving. While the *takāful* sector still accounts for a small share of the financial system in most of these countries, given its high growth rates it has the potential to be an important and integral part of the financial system. In this respect, analysing the resilience of the *takāful* industry helps to secure both its own health and the stability of other segments of the financial system which have interlinkages with the *takāful* sector.

In the light of the fact that the *takāful* sector is a subset of the insurance sector and is closely interconnected with the conventional insurance sector, it is not possible to evaluate the former without taking the resilience landscape of the latter into account. In this respect, some of the resilience-related issues in the conventional insurance sector for the countries in which Islamic finance has been thriving are also covered.

Resilience of the insurance sector can be defined as the ability of the industry to deal with the shocks that can affect profits, balance sheets and investment decisions, and to recover from the effects of this shock in a timely and efficient manner, and while maintaining its ability to pay valid claims.

While the insurance industry shares some common features with other financial institutions with respect to resilience, especially with the banking industry, the working principles of the banking and insurance sectors are different, thus exposing these two sectors to different risks. Banks typically perform maturity transformation from short-term funding from their depositors to long-term financing to their clients and/or investments. They should therefore have a positive duration mismatch in their balance sheets. On the other hand, the life insurance segment of the insurance sector typically collects long-term funding from its clients and invests these funds in medium- to long-term financing. Their duration mismatch is therefore negative in generall.[191] In general insurance, clients have no option to withdraw their funds except when they make claims for losses, and in most categories the claims profile typically extends over a few years. Thus, insurance companies are much less prone to liquidity risks and runs. They are, however, exposed to substantial solvency risks, especially in general insurance. These risks differ from those in banking, in that risks on the asset side of the balance sheet are much less significant than those on the liability side, notably the claims that will be made against the risks that have been covered. There is also empirical evidence from its response to past major disasters that interconnectedness within the insurance industry, primarily through the major reinsurers, operates to disperse, rather than concentrate, risk.

As regards the connection with other sectors, an important paper [192] by Podlich and Wedow suggests that the impact of default risk for the banks on insurers is more than three times as high as the effects of insurance companies on banks. Transmission of risks from banks to insurance companies is therefore a more important channel than the reverse. However, insurers, especially life insurers, which control large pools of investable assets, may have important effects on asset prices in capital markets.

Resilience in the insurance sector, whether in the form of conventional insurance or *takāful*, can be evaluated under two interconnected rubrics[193] with a high degree of feedback and endogeneity. The first rubric covers how the institutional scaffolding, economic conditions and regulations have effects on the industry overall, and we call it "external conditions". The second is more related to the internal structure and operational aspects of the industry, including, but not limited to, financial structure and investment decisions of the operators. We call this "internal conditions", which can be gauged with financial ratios and investment composition of the assets. Resilience of the *takāful* sector is evaluated in the light of this classification in the rest of the section. Due to the fact that external conditions overlap for both of the *takāful* and its conventional counterpart to a large extent, recent global developments and regulations that affect both segments are emphasised.

3.3.1 External Conditions

At the global level, non-life premium growth was slower in 2015 (2.5% in real terms) than in 2014 (2.8% in real terms), while the picture was better in the emerging countries with a growth rate of 5.6%. On the other hand, the growth rates of premiums in emerging Asia (excluding China) and MENA were higher than the emerging markets' average,

[191] The Geneva Association (2012), *Insurance and Finance,* No. 9.
[192] N. Podlich and M. Wedow (2013), "Are Insurers SIFIs? A MGARCH Model to Measure Interconnectedness", *Applied Economics Letters,* Vol. 20.
[193] Deutsche Bundesbank (2014), *Monthly Report No. 67,* July.

indicating strong growth in these regions due mostly to the higher demand for motor vehicles.[194] The global economic outlook for 2016 is expected to be improved in the emerging markets, and this can also positively affect the non-life insurance and general *takāful* segments concurrently. Similarly, the growth rate of life insurance premiums was still positive in 2015 at the global level, while the business environment will continue to be challenging in 2016.

Because major risks are generally transmitted into the global reinsurance market, pricing in that market strongly influences pricing levels for insurance, especially general insurance, more generally. Indeed, overcapacity in the reinsurance market and the resulting low reinsurance rates in the past few years have resulted in a total alternative capital rate of 7% in the first half of 2015 and a market share of 12.1% of total reinsurer capital.[195] The reinsurance market is highly cyclical, and prices have been generally declining over the last two to three years. This has had a limited effect on profitability, because there have been few major catastrophes and because of reserve releases,[196] but these soft pricing conditions and reserve reductions may increase the risks to reinsurers for the future. Any reinsurer failure clearly impacts immediately on its direct insurance clients, but soft pricing also affects those insurers less dependent on the reinsurance market and may therefore affect their stability.

Interestingly, the low interest rate environment and moderate economic growth have not led to a sharp decline in investment returns. There seem to be three reasons for this.[197] First, only a portion of fixed-income instruments matured in 2015, and the insurers enjoyed the benefit from higher returns of the past years. Second, the stock-market rally, especially in the developing countries, has helped positive investment returns. Third, in the low interest rate environment,[198] life insurers have reshuffled some of their portfolios to higher-risk, less-liquid assets such as infrastructure, private equity and joint ventures.

In general, low interest rates may give rise to changes in the structure of the insurance sector, such as the changing financial investment portfolio of the insurers, merging with competitor companies and re-organisation of the operational units for cost-effectivenes.[199] Thus, both in the conventional and *takāful* segments, the aforementioned global conditions may lead firms to merge.

Another component of external conditions is recent regulations in the insurance sector with implications for the *takāful* sector. Insurance regulators globally have been enhancing their prudential frameworks, which have generally lagged behind those in the banking sector. The most conspicuous development has been the European Solvency II framework, but there have also been regulatory developments, some of them specific to *Takāful*, in the countries of most interest to Islamic finance. As the *takāful* sector has a relatively important share only in the GCC and the East Asia and South Asia regions, a general overview of the regulatory attempts only in these regions is provided below.

In the GCC region, significant regulatory changes have happened since 2014. The regulators have improved standards and brought, to a certain extent, both their conventional and *takāful* industries to the international standards of the conventional insurance sector, such as an emphasis on risk-based solvency policies. In the long term, these measures are considered to be better for the *takāful* firms in terms of capital management, liquidity, internal controls and corporate governance.[200] On the other hand, they are expected to increase the costs in the *takāful* sector, at least in the short run, due to the fact that many operators are working below their efficient scale with already high overheads. Indeed, 72 operators in the GCC region competed for USD9.6 billion in gross contributions in 2014, with an average contribution per operator of USD134 million. This number is quite low in international insurance sector terms.

Another expected impact of the regulations on GCC operators is higher costs of compliance in firms that are already relatively inefficient. Absent withdrawals or mergers, operators in the GCC region need to find ways to increase penetration ratios to survive under these new regulations. According to a recent Standard & Poor's report, an important way for *takāful* operators to maintain and/or to increase their profit levels in mixed systems is through product differentiation from their conventional counterparts, especially in the motor insurance market.[201] Another option is to diversify away from the crowded market in the GCC by targeting unchartered markets with high potential growth in *takāful*, such as Africa.[202] Introduction and extension of compulsory lines such as motor and medical insurance are the major drivers of gross premium growth in the GCC, because of the fact that over 80% of the business

194 Swiss Re (2015), *Global Insurance Review 2015 and Outlook 2016/17,* November.
195 IAIS (2015), *Global Insurance Market Report.*
196 Guy Carpenter (2015), *The Reinsurance Landscape,* July.
197 Swiss Re (2015), *Global Insurance Review 2015 and Outlook 2016/17,* November.
198 While the Fed is expected to gradually increase the federal funds rate in the forthcoming periods, it will still be low in historical terms. Moreover, in other regions such as the Euro area and Japan, a low interest rate policy will still continue.
199 Swiss Re (2015), *Global Insurance Review 2015 and Outlook 2016/17,* November.
200 Standard & Poor's (2015), "Regulatory Changes Cause a Shakeout in Gulf Islamic Insurance Markets", *Islamic Finance Outlook 2016.*
201 Standard & Poor's (2015). "Regulatory Changes Cause a Shakeout in Gulf Islamic Insurance Markets", *Islamic Finance Outlook 2016.*
202 Standard & Poor's (2015). "Regulatory Changes Cause a Shakeout in Gulf Islamic Insurance Markets", *Islamic Finance Outlook 2016.*

comes from the non-Life segment.[203] Indeed, Standard & Poor's analysis shows that there is a positive association between having higher profits and focusing on medical insurance activities, so compulsory health coverage can help to sustain resilience of the operators in the region.[204]

In South-East and South Asia regions, Malaysia, Indonesia and Bangladesh have the highest volume of gross contributions. A key challenge in these regions is to set up effective and comprehensive distribution channels and marketing of insurance products. In this respect, both the insurance and *takāful* operators have increasingly relied on links with banks in the form of bancassurance and banca*takāful*.

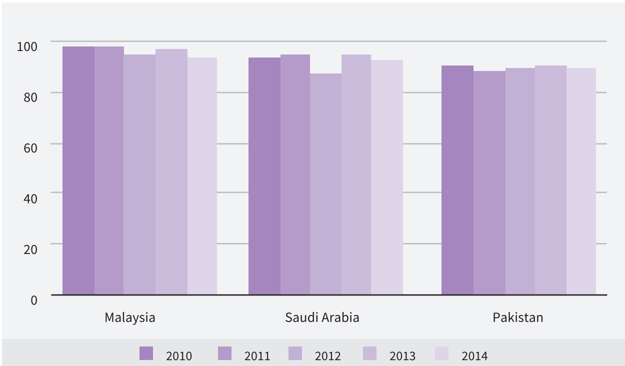
As indicated before, internal factors also play an important role in evaluating the resilience of the *takāful* sector. In this respect, some selected financial ratios and analysis of the investment composition of the business can give important insights into the level of resilience of the sector. In general, financial structures of the insurance operators, both of the conventional and *takāful* segments, have suffered from the low interest rate environment, slow economic recovery and weak growth outlook in the post-crisis era.

3.3.2 Internal Conditions

As evaluation of internal conditions requires analysis of financial ratios and balance sheets of the operators, this section focuses on four countries selected on the basis of data availability and their locations in different regions. Given the consolidated financial accounts for each country in the sample, the operators' risk retention ratio,[205] return on assets, claims ratio and operations ratios are calculated, and their investment composition is examined.[206]

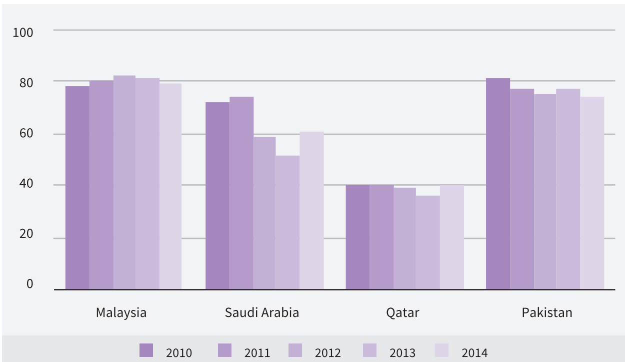
Due to the fact that the risk retention ratio depends also on the type of risk, which is specific for each line of business, it is evaluated separately for the General and Family segments in the sample. As per risk retention ratios in the family *takāful* segment (see Chart 3.3.2.1), in all countries in the sample the ratio is over 90%, with Malaysia and Saudi Arabia recording ratios a little higher than that of Pakistan. The risk retention ratio in the general *takāful* business is a more important indicator than that in the Family business, for the reasons explained in the footnote. As shown in Chart 3.3.2.2, Qatar and Saudi Arabia seemingly manage the underwriting risks in the general *takāful* segment better than do Pakistan and Malaysia.

Chart 3.3.2.1
Risk Retention Ratio in Family *Takāful* (2010–2014)



** Data for Qatar were not available.*
Source: IFSB Secretariat Workings

Chart 3.3.2.2
Risk Retention Ratio in General *Takāful*(2010–2014)



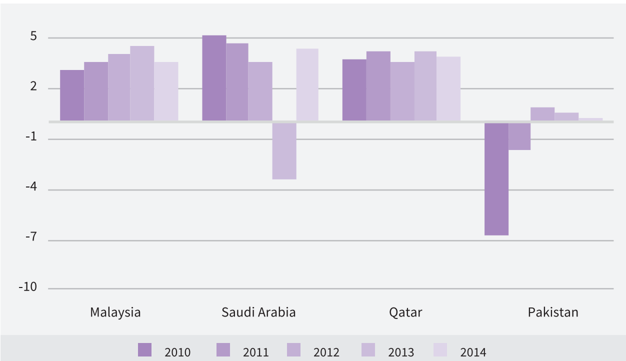
Source: IFSB Secretariat Workings.

Return on assets in all of the sample countries was positive in 2014 (see Chart 3.3.2.3), ranging from 0.3% in Pakistan to 4.4% in Saudi Arabia. Increasing costs are one aspect of this outcome, but slower global growth, the decline in oil and commodity prices, and other global and regional developments impede high returns on assets. Only Saudi Arabia had a quite robust ROA in 2014 after a significant slump in 2013. In Malaysia, apart from the aforementioned general triggers, the introduction of new regulations, such as the Financial Services Act in 2013, and low returns on investments were possibly important

[203] Swiss Re (2015), Re/insurance in the Middle East 2014.
[204] Standard & Poor's (2015), *"Regulatory Changes Cause a Shakeout in Gulf Islamic Insurance Markets", Islamic Finance Outlook 2016.*
[205] The risk retention ratio can be defined as the ratio of net premiums to gross premiums. It is a reflection of the insurers' underwriting strategy, as it shows what portion of the risk is passed to the reinsurer company/*retakāful* operator. The risk retention ratio depends also on the type of risk, which is specific for each line of business. It is commonly higher for high-frequency, low-severity risks such as motor than for low-frequency, high-severity risks such as aviation. In particular, where the premium includes a large investment element, as is common in some family *takāful*, the proportion that covers mortality risk is in any event relatively small. In these circumstances, the risk retention level will be low even if a large part of the mortality risk is reinsured. Hence, different structures of the *takāful* industry can also explain differences in retention ratios between countries and do not necessarily indicate more sophisticated operational capabilities or a better underwriting risk management. It should also be kept in mind that higher risk retention ratios signify that less risk is ceded to *Retakāful*, by indicating less dependence on *retakāful* operators.
[206] A database is formed with key financial statements extracted from the annual financial reports of a set of *takāful* operators from selected countries. These numbers are then consolidated. While the goal is to come up with a representative sample, due to the lack of availability of consistent data over a period of years for many of the countries in which the *takāful* sector operates, the sample consists of four countries, each of which is from a different region. In the selection process, countries with a high coverage ratio, which can be defined as the ratio of gross contributions in the dataset to the gross contributions given in the World Insurance Directory, are considered. The countries covered in the analysis and their coverage ratios are as follows: Saudi Arabia (46.3%), Malaysia (58.2%), Qatar (63.3%) and Pakistan (97%).

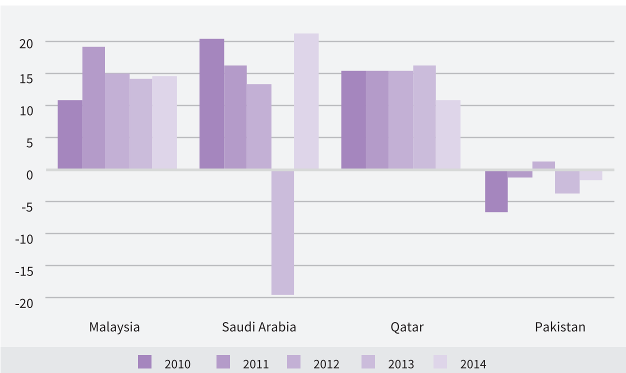
reasons for declining ROA in 2014. General *takāful* comprises all of the market in Qatar, so general economic developments are more relevant to the profitability of the *takāful* sector in Qatar compared to Malaysia. It can be speculated that the worsening economic conditions, rather than regulation, contributed to declining ROA in Qatar. Dissimilar to other countries in the sample, ROA rose significantly in 2014 from its negative level in 2013. The general *takāful* segment accounts for around 98% of the *takāful* sector in Saudi Arabia. The health and motor business lines comprise the bulk of the general *takāful* business. The government's introduction of mandatory insurance in the health and motor segments is responsible for the positive and high ROA in Saudi Arabia. Return on equity of the *takāful* operators gives a similar picture in the sample over the years (see Chart 3.3.2.4).

Chart 3.3.2.3
Return on Assets in the Sample Markets (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

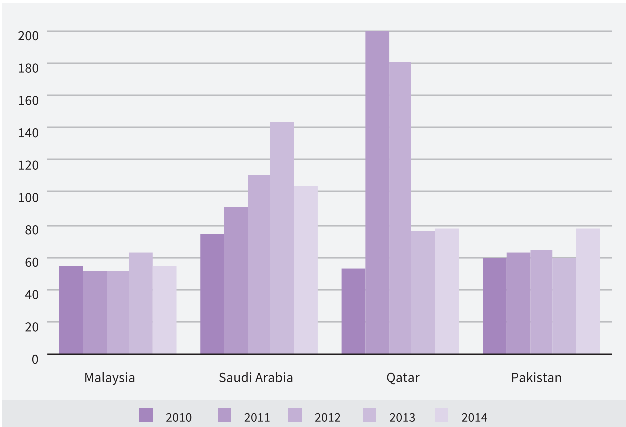
Chart 3.3.2.4
Return on Equity in the Sample Markets (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

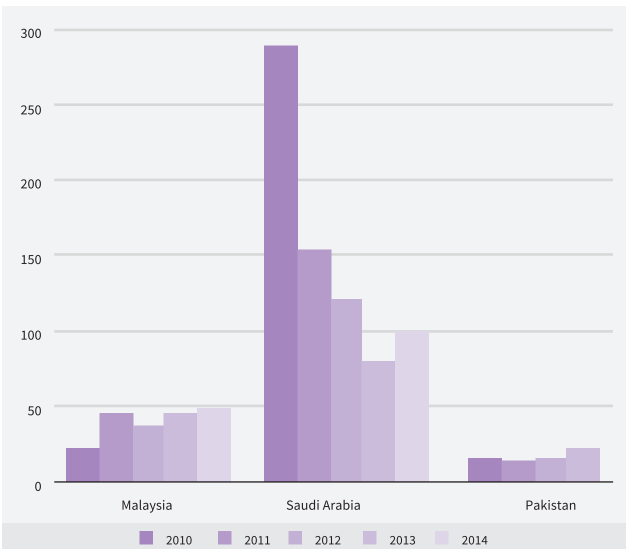
Regarding the claims ratio,[207] Charts 3.3.2.5 and 3.3.2.6 illustrate comparative trends in the general and family *takāful* segments, respectively, for the sample countries.[208] For general *takāful*, different countries have different trends in terms of their claims ratio. In Malaysia, the claims ratio is quite stable, hovering around the 60% level. It is also stable in Pakistan, with the exception of in 2014. In Saudi Arabia, the claims ratio rose rapidly until 2013 and then returned to its 2012 level. The most interesting case is Qatar, whose claims ratio overshot to around the 200% level, possibly due to high realisation of claims in the 2011–2012 period. On the other hand, claims ratios for the family *takāful* segment are low in Malaysia and Pakistan, though in an increasing trend. In the family *takāful* segment, Saudi Arabia has a very high claims ratio but a decreasing trend.

Chart 3.3.2.5
Claims Ratio in General *Takāful* (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings

Chart 3.3.2.6
Claims Ratio in Family *Takāful* (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

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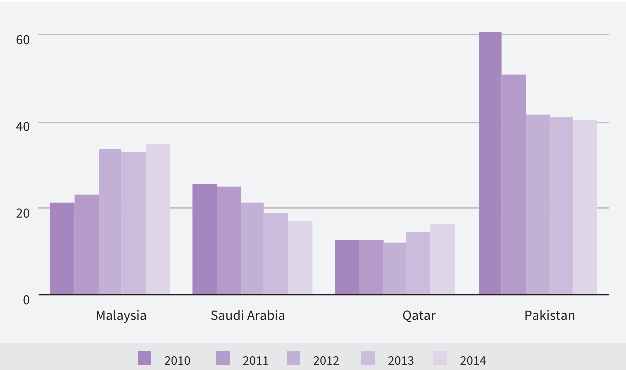
[207] Claims ratio = net claims incurred / net contributions.
[208] This decomposition is mostly due to the fact that family and general *takāful* contributions have distinct components. In family *takāful*, the participants' contribution consists of the risk component (the contribution for covering mortality and longevity) and the savings component (money invested for long-term savings purposes). On the other hand, the general *takāful* business doesn't have the latter component.

In addition to the claims ratio, the expense ratio is important for gauging the profitability of the sector. As shown in Chart 3.3.2.5, expenses decreased in Pakistan and Saudi Arabia, while they were in an increasing trend in Qatar and Malaysia.[209]

Chart 3.3.2.7
Expense Ratio in Sample Countries (2010–2014)

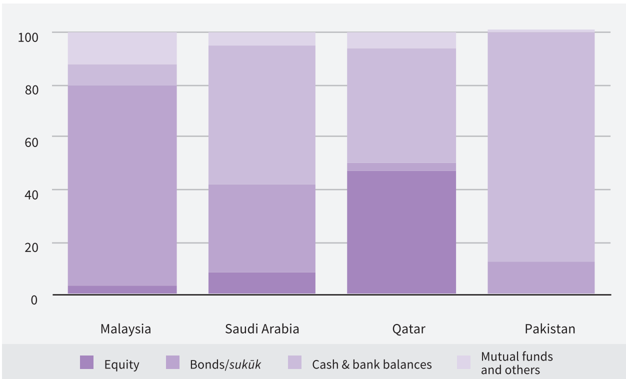


Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Investment compositions of the *takāful* operators in the sample reflect different market conditions and instruments available as of 2014. In general, *takāful* operators have separate *takāful* funds with respect to family and general *takāful* businesses. A generic family *takāful* firm has a shareholders' fund (SHF), participants' risk fund (PRF) and participants' investment fund (PIF).[210] On the other hand, a generic general *takāful* firm has only two funds – namely, the PRF and the SHF. As the investments by each of these funds have different implications for the resilience of the operator, we evaluate these funds separately. Due to data availability, at the country level, we analyse the fund under three rubrics, in which the general *takāful* fund encompasses only the PRF of the general *takāful* firms, the family *takāful* firm encompasses the PRF and the PIF of the family *takāful* firms, and the aggregate shareholders' fund covers the SHF of the family and general *takāful* firms. This is due to the fact that we do not have detailed decomposition of the SHF for general and family businesses for the operators that have mixed businesses.

Regarding the general *takāful* funds, *sukūk* is the dominant investment instrument in Malaysia and has the highest share within the sample. On the other hand, investment composition is a bit more diversified in Saudi Arabia, in which cash and deposits have the biggest share of the pie, followed by *sukūk*. The high share of cash and bank balances in Saudi Arabia is associated with the high share of the non-Life business, whose relatively short-term claims development profiles direct the assets into correspondingly short-term investments. Contrary to the situation in other countries in the sample, the equity market is the most important domain of investment in Qatar, followed by cash and bank balances. The high share of the equity instruments is interesting because general *takāful* dominates the market, which requires short-term investment. In Pakistan, distribution of the investments is almost totally dominated by cash and bank balances.

Chart 3.3.2.8
Investment Composition for General *Takāful* Funds (2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Regarding the family *takāful* funds, the dataset gives information only for Malaysia and Pakistan. Similar to the general *takāful* funds, *sukūk* is the dominant investment instrument in Malaysia as a reflection of leaning towards fixed-income instruments due to the high share of family *takāful* as a long-term investment area and the well-developed *sukūk* market. In Pakistan, the investment portfolio of the family *takāful* is more distributed compared to general *takāful* investment funds. Indeed, *sukūk* and mutual funds account for quite a high percentage of the family *takāful* portfolio as a reflection of the long-term investment needs of these funds.

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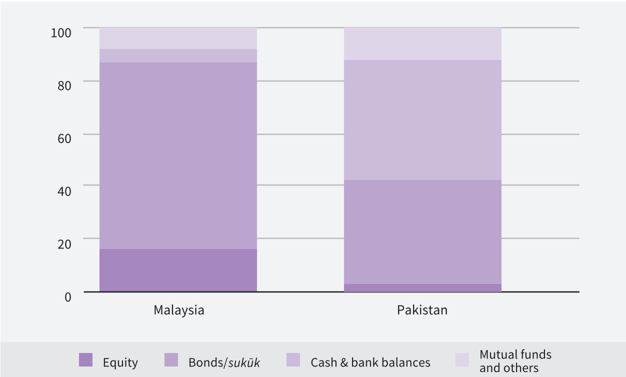
[209] Availability of the data didn't allow us to look into the expense ratio separately for the family and general *takāful*, so the chart gives a consolidated picture of the sector with respect to the expense ratio.

[210] BNM defines these funds as follows: "The PRF is compulsory for all products and refers to the fund used to pool the portion of contributions paid by participants on the basis of tabarru' (donation) or the purpose of meeting claims on events/risks covered under the *takāful* contracts. For annuity products, the PRF shall be used to pool the *tabarru*' contributions meant to provide payments during the annuity period. Under the *tabarru'* contract, the fund is owned by the pool of participants. In managing the PRF, the *takāful* operators shall adopt appropriate set of policies and procedures to ensure the availability of funds to meet *takāful* benefits when due. The PIF refers to the fund in which a portion of the contributions paid by *takāful* participants for a *takāful* product is allocated for the purpose of savings and/or investment. The PIF is individually owned by participant. In managing the PIF, *takāful* operators shall adopt appropriate investment and management strategies to achieve returns that are in line with the participants' reasonable expectations and where relevant, to ensure the availability of funds for future *tabarru'* apportionment into the PRF. For investment-linked *takāful*, the PIF shall refer to the unit fund(s)."

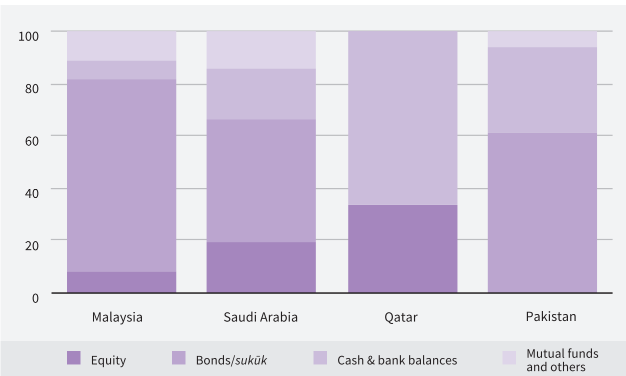
Chart 3.3.2.9
Investment Composition for Family *Takāful* Funds (2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Regarding the SHF, *sukūk* comprise 73% of the investment portfolio in Malaysia, which is the highest ratio of *sukūk* holding in the sample. Similar to the distribution of the general *takāful* funds, investment composition is more diversified in Saudi Arabia, in which *sukūk* has the biggest share of the pie, followed by cash and deposits. Unlike the other countries, investment portfolios in Qatar are composed of only two instruments: equity, and cash and deposits. Similar to the general *takāful* funds' portfolio, the equity market is the most important investment domain for aggregate shareholder funds. In Pakistan, *sukūk* has quite a high share, followed by cash and deposits.

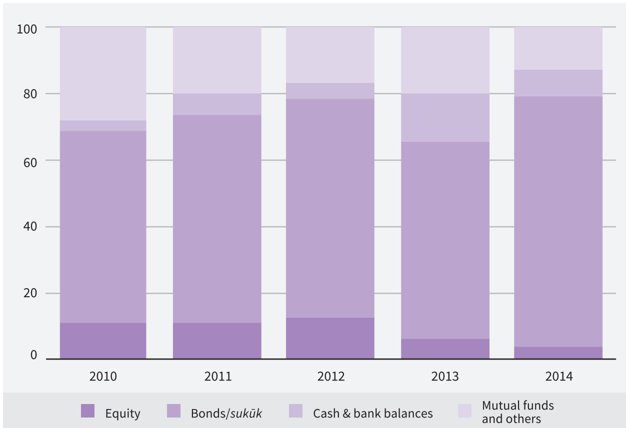
Chart 3.3.2.10
Investment Composition for Aggregate Shareholders' Funds (2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

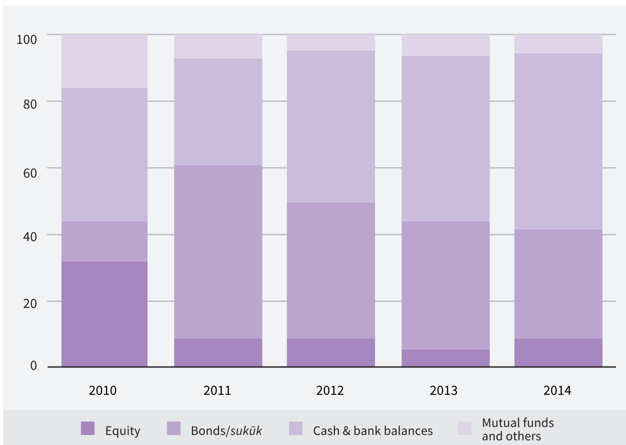
In addition to level of investment composition in 2014, historical trends are also important. As the general *takāful* is more relevant from the point of view of resilience, historical trends in the general *takāful* funds are illustrated in the following charts. In Malaysia (see Chart 3.3.2.11), share of *sukūk* has an increasing trend, except in 2013, through its gradual substitution for other investments (mutual funds, investment accounts, etc.) and equity. In Saudi Arabia (see Chart 3.3.2.12), the most important change in the portfolio has been the slump in the share of equity. Over just five years, equity's share decreased from 53.6% to 9.3%, replaced mostly by *sukūk*, especially after 2011, as a reflection of developments in the *sukūk* market in that year, such as government regulations in the *sukūk* market, a low interest rate environment and high liquidity, which are all conducive to a vibrant Islamic capital market. Moreover, high volatility in the equity market before 2011 gave rise to increased interest in the *sukūk* market. However, since 2011, it seems that cash and deposits have gradually supplanted *sukūk* investments. In Qatar (see Chart 3.3.2.13), the investment portfolio is shared between equity and cash and deposits investments. Finally, in Pakistan (see Chart 3.3.2.14), cash and balances is almost the sole investment instrument for the general *takāful* Operators. While there was an increasing trend of *sukūk* between 2010 and 2013, its share declined abruptly in 2014 as a reflection of desperate global economic conditions.

Chart 3.3.2.11
Evolution of Investment Portfolio of General *Takāful* Funds in Malaysia (2010–2014)



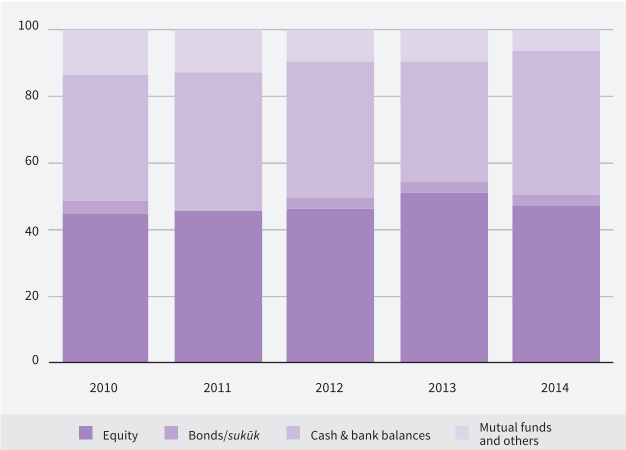
Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Chart 3.3.2.12
Evolution of Investment Portfolio of General *Takāful* Funds in Saudi Arabia (2010–2014)



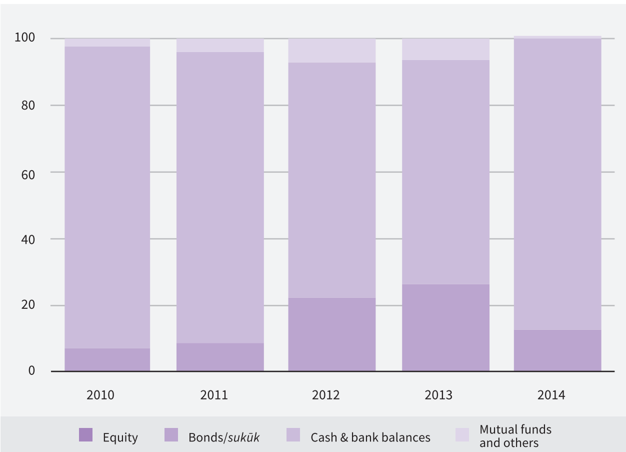
Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Chart 3.3.2.13
Evolution of Investment Portfolio of General *Takāful* Funds in Qatar (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

Chart 3.3.2.14
Evolution of Investment Portfolio of General *Takāful* Funds in Pakistan (2010–2014)



Source: Financial reports of selected Takāful Operators, IFSB Secretariat Workings.

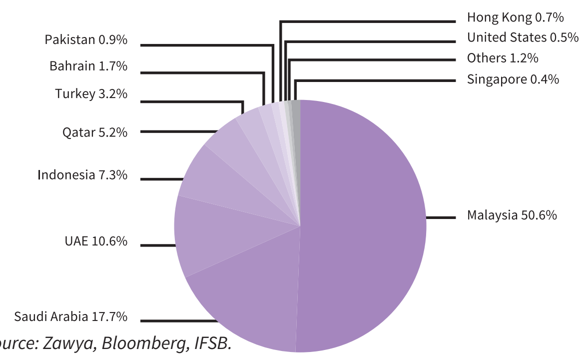
Overall, while data are limited, and despite a soft period in the global insurance cycle and low investment returns, the *takāful* sector appears relatively robust. Its position has been enhanced by advances in solvency regulation in key markets, especially in the GCC and East Asia regions and, for the general *takāful* industry in particular, by the gradual expansion of compulsory insurance requirements in areas such as motor and health. Nevertheless, the small size of many *takāful* undertakings is a source of concern, and it is likely that one consequence of improved regulation will be consolidation of the sector in some countries. On the financing side, investment opportunities for the *takāful* sector continue to be constrained by the availability of appropriate Sharī'ah-compliant investment products, which in turn affects the returns that *takāful* firms are able to achieve. In this respect, sovereign issuance of *sukūk* and access to equity markets becomes more important.

3.4 ISLAMIC CAPITAL MARKET: ASSESSMENT OF ITS RESILIENCE

(a) *Sukūk* market

The global *sukūk* market has undergone a moderation in issuances and outstanding values in 2015 on account of several macroeconomic rebalancing activities in the global economy.[211] In particular, a depreciation in several emerging market currencies has had an impact on the *sukūk* outstanding value in US Dollar terms; as of 11M15, the global *sukūk* outstanding was valued at a little under USD291 billion, which compares with the USD300.3 billion outstanding as of end-2014. The nearly 3.4% contraction in outstanding value is despite a nearly unchanged number of *sukūk* tranches outstanding; as of 11M15, the relevant databases[212] capture 2310 *sukūk* issuances outstanding from obligors domiciled in 25 countries, which is almost similar to the numbers reported in the previous stability report. Among these 25 countries, eight are non-OIC member states, including four from the European Union (France, Germany, Luxembourg and the UK); two in Asia (Singapore and Hong Kong); and one each in Africa (South Africa) and North America (the US). The top five largest *sukūk* markets in terms of outstanding values are also consistent with previous trends (see Chart 3.4.1): Malaysia in the lead (50.6%), followed by Saudi Arabia (17.7%), the UAE (10.6%), Indonesia (7.3%) and Qatar (5.2%). The proportions in these top five, however, have changed, with the latter four gaining market share in 2015 at the expense of a contraction in Malaysia's share. This is due mainly to the fixed exchange rates regime in the GCC that has sustained outstanding values in US Dollar terms, as well as to two key US Dollar *sukūk* issuances worth a total of USD2.5 billion in Indonesia in 2015. Furthermore, a contraction in overall primary issuances in the Malaysian market (due to a halt in issuances by BNM) has also impacted the outstanding share for Malaysia.

Chart 3.4.1
Top Ten Global *Sukūk* Outstanding Domiciles (11M15)



Source: Zawya, Bloomberg, IFSB.

The demand from investors for new *sukūk* issued in the primary market has remained resolute in spite of the weaker sentiments in the global capital markets. Most of

[211] As has also been highlighted in Chapter 1 of this report.
[212] Zawya, Bloomberg, IFSB.

the international *sukūk* issued in 2015 had been oversubscribed (see Table 3.4.1), with the five-year USD500 million corporate *sukūk* issued by Sharjah Islamic Bank in the UAE attracting the highest investor interest. (Order books were oversubscribed by 7.2 times.) In the sovereign sector, the ten-year USD1.0 billion *sukūk* by the Malaysian government attracted the highest investor interest, with an oversubscription by almost 7 times in the order books. A debut five-year USD500 million corporate *sukūk* issued by Noor Bank, an Islamic bank in the UAE, also attracted substantial investor interest, with order books oversubscribed by 4.3 times. The international *sukūk* listings in 2015 attracted diverse sovereign, MDB, corporate and GRE issuers bearing a variety of credit ratings ranging from being unrated to the prime-grade AAA. The Emirates Airline *sukūk* notably has been underwritten by UK Export Finance, a government-backed export credit guarantee agency, marking a first for the UK government. The USD913 million tranche is to be used by Emirates Airline, a Dubai government-owned entity, to fund aircraft acquisitions, and this programme was oversubscribed by 3.6 times.

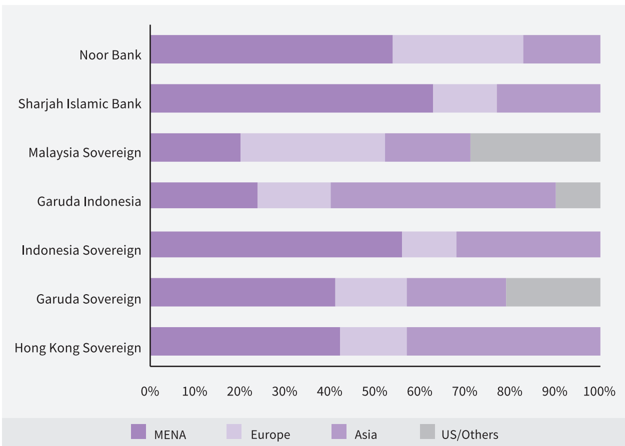
Table 3.4.1
Demand Comparison for Selected *Sukūk* Issued in 2015

Sukūk Name*	Issue Size (USD million)	Issuer Type	Tenure (years)	Rating	Oversubscription (times)
Emirates Airline 3/25	913	GRE	10	NR	3.6
DIB Tier 1 *Sukūk*	1000	Corporate	Perp	A / (Fitch)	2.5
Malaysia Sovereign *Sukūk* 4/25	1000	Sovereign	10	A- / (S&P)	6.9
Indonesia Sovereign 5/25	2000	Sovereign	10	BBB- / (Fitch)	3.4
Hong Kong Sovereign 6/20	1000	Sovereign	5	AAA / (S&P)	2.0
MAF *Sukūk* Ltd 10/25	500	Corporate	10	BBB / (Fitch)	3.1
Oman Sovereign *Sukūk* 11/20	650	Sovereign	5	A1 / (Moody's)	1.7
QIB Islamic Bank 10/20	750	Corporate	5	A- / (S&P)	2.3
APICORP *Sukūk* 10/20	500	Corporate	5	Aa3 / (Moody's)	1.7
Sharjah Islamic Bank 3/20	500	Corporate	5	BBB+ / (Fitch)	7.2
Noor Bank 4/20	500	Corporate	5	A- / (Fitch)	4.3
Ras Al Khaimah 4/25	1000	Sovereign	10	A / (Fitch)	2.5

NR = not rated; Perp = perpetual.
**Numbers in "Sukūk Name" indicate maturity date mm/yy.*
Source: Various references, IFSB.

The geographical allocation of international *sukūk* issuance remains well-diversified, with the Middle East region continuing as an important source for *sukūk* subscriptions (see Chart 3.4.2). In addition, steady orders were placed by investors from the European and North American regions where a low interest rate environment has encouraged investors to seek higher-yielding international currency opportunities available in the Middle East and emerging markets. The share of Asian investors was particularly high in *sukūk* floated by issuers in Asia (e.g. Malaysian Sovereign *Sukūk*, Hong Kong Sovereign *Sukūk*).

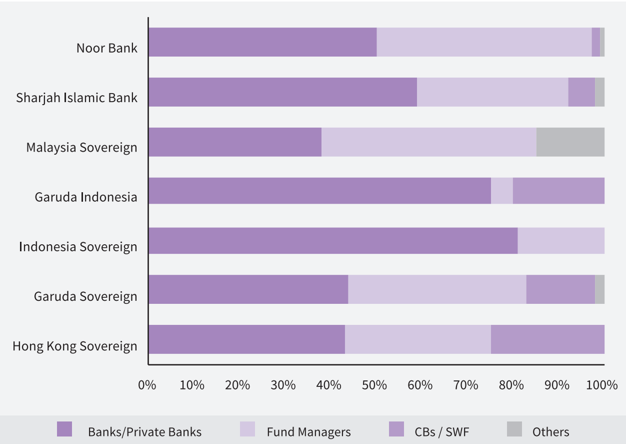
Chart 3.4.2
Geographical Distribution of Selected *Sukūk* Papers Issued in 2015



MENA = Middle East and North Africa; US = United States.
Source: Various references, IFSB.

In terms of investor allocations, banks/private banks and fund managers almost entirely dominated the market, while investments from central banks, sovereign wealth funds and others such as pension funds remained marginal (see Chart 3.4.3). The share of central banks and sovereign wealth funds, however, was comparatively higher in AAA-rated *sukūk* instruments issued by the World Bank and the Hong Kong government. This possibly indicates that, due to the specific mandates of such institutions, their investments are inclined towards prime-rated international securities.

Chart 3.4.3
Investors' Breakdown of Selected *Sukūk* Papers Issued in 2015



CBs / SWF = Central Banks / Sovereign Wealth Funds; Others = Pension Funds, Takāful/Insurance Funds, etc.
Source: Various references, IFSB.

Sukūk Defaults

The *sukūk* market has also continued its resilient performance when measured by the proportion of defaulted *sukūk* in comparison to the total issuances to date. As of November 2015, out of almost USD1.12 trillion worth of funds raised by *sukūk*, only USD1.85 billion, or 0.17% of the total issuances volume, has defaulted (see Table 3.4.2). The *sukūk* market has also averted any defaults since 2010, although there has been a restructuring as recently as in 2013. In general, the improvements and clarity in *sukūk* resolution frameworks, combined with an improved understanding of risks by investors, have been a catalyst in averting instances of *sukūk* defaults in recent years, and stakeholders are more willing to adopt a path of restructuring, if necessary. The complexity of the Islamic financial instruments, which need the attention of Sharī'ah experts in dealing with disputes, is contributing to the use of alternative dispute resolution mechanisms. A number of countries (e.g. Malaysia, Qatar, the UAE) have established local arbitration centres to resolve disputes in Islamic finance.

Table 3.4.2
Defaulted and Restructured *Sukūk* (1990 to November 2015)

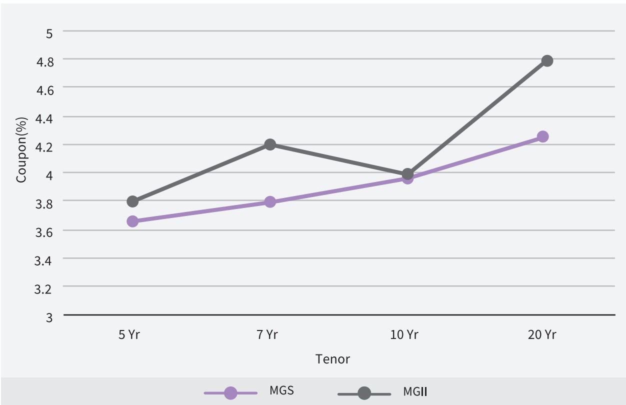
	No. of *Sukūk* Tranches	No. of Issuers	Total Volume (USD billion)
Total issued	11,500	679	1,119.3
Total defaulted	129	26	1.85

Source: Bloomberg, IFSB.

Premium Pricing on New Issues

Sukūk issuances continued to attract premiums on pricing in 2015, even in markets characterised as highly liquid with deep and active secondary markets. For instance, in 2015, the Malaysian government's *sukūk* issuances attracted additional premiums in the range of 15bps to 50bps across tenors of five years to 20 years when compared with identical bond issuances (see Chart 3.4.4). Similarly, the Indonesian ten-year sovereign *sukūk* issuance worth USD2.0 billion was priced at a premium of 20bps (4.325%) when compared with a similar ten-year sovereign bond issuance (4.125%) worth the same amount. Among the new markets, the debut sovereign *sukūk* issuance by the Sultanate of Oman was priced at a premium of 50bps (3.50%) when compared with a similar ten-year Omani government bond (3.0%) that was priced just a few weeks earlier to the *sukūk* transaction.

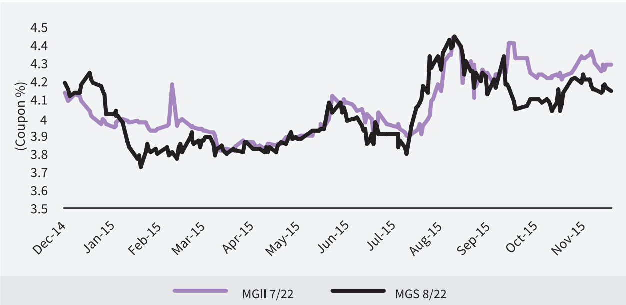
Chart 3.4.4
***Sukūk* and Bond Pricing Comparison in Malaysian Primary Market (2015)**



MGS = Malaysian Government Securities (Bond); MGII = Malaysian Government Investment Issue (Sukūk).
Source: Bloomberg, IFSB

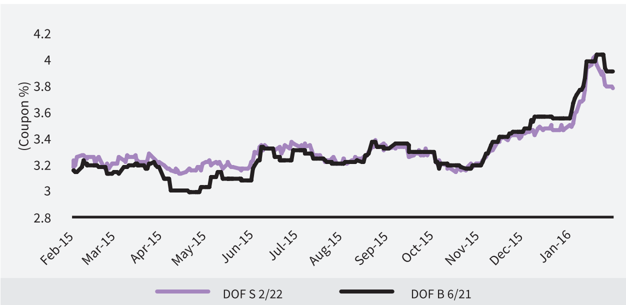
The widely held view stipulates that these additional premiums on *sukūk* are offered as incentives to investors to compensate for the lack of familiarity with and lower liquidity of the *sukūk* papers when compared with conventional instruments. Nonetheless, when analysing secondary market *sukūk* yields in three sample markets (Malaysia, the UAE and Qatar), there is no clear and identifiable pattern over the past 12 months to suggest that *sukūk* always trade at comparatively higher secondary market yields to identical bonds (see Charts 3.4.5(a), 3.4.5(b) and 3.4.5(c)). This issue needs further consideration and investigation by the relevant stakeholders, particularly since premium pricing on *sukūk* issuances are in fact higher funding costs for the issuers and this could potentially discourage some issuers from tapping the market.

Chart 3.4.5(a)
***Sukūk* and Bond Pricing Comparison in Malaysian Secondary Market (2015)**



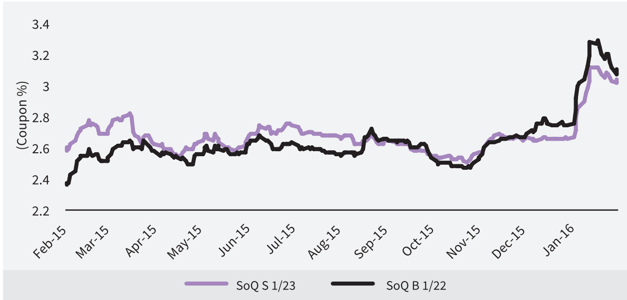
**Numbers in "Sukūk Name" indicate maturity date mm/yy.*
MGS = Malaysian Government Securities (Bond); MGII = Malaysian Government Investment Issue (Sukūk).
Source: Bloomberg, IFSB.

Chart 3.4.5(b)
***Sukūk* and Bond Pricing Comparison in UAE Secondary Market (2015)**



**Numbers in "Sukūk Name" indicate maturity date mm/yy.*
DOF S = Dubai Department of Finance sukūk; DOF B = Emirate of Dubai International Bond.
Source: Bloomberg, IFSB.

Chart 3.4.5(c)
***Sukūk* and Bond Pricing Comparison in Qatar Secondary Market (2015)**

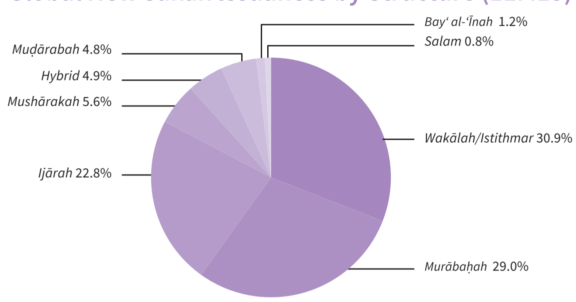


**Numbers in "Sukūk Name" indicate maturity date mm/yy.*
SoQ S = State of Qatar sukūk; SoQ B = Qatar International Government Bond.
Source: Bloomberg, IFSB.

Sukūk Structures

In recent years, *sukūk* structures have begun to substantially utilise fixed-returns sales-based Sharīʻah-compliant contracts (e.g. *ijārah* and *murābaḥah*), which generally perform in a financially similar way to conventional bonds. The use of partnership contracts – namely, *mushārakah* and *muḍārabah* – has greatly been reduced in the *sukūk* market. Nonetheless, in 11M15, the proportion of partnership *sukūk* structured on *mushārakah*, *muḍārabah* and *wakālah* has increased substantially, to 41.3% (2014: 19.5%), due mainly to a smaller volume of issuances in Malaysia and, generally, an increase in issuances of IIFS regulatory capital *sukūk* (see Chart 1.3.4.6). The *murābaḥah* contract is more popular among issuers in Malaysia, whereas *wakālah* and *ijārah* – and to some extent, *mushārakah* – are popular among the GCC issuers. The difference in preference between Malaysia and the GCC draws upon the respective Sharīʻah rules of these markets; the *murābaḥah sukūk* is generally not permissible to be traded at values other than par in the GCC; whereas in Malaysia, the Sharīʻah Advisory Council of BNM permits *sukūk* structured on 100% receivables to be traded at values other than par.[213] As of 11M15, the proportion of global *sukūk* outstanding by structure is as follows: *ijārah* (27.3%), *murābaḥah* (24%), *wakālah*/istithmar (18.1%), *mushārakah* (16.9%) and others (13.7%) (see Chart 3.4.7).

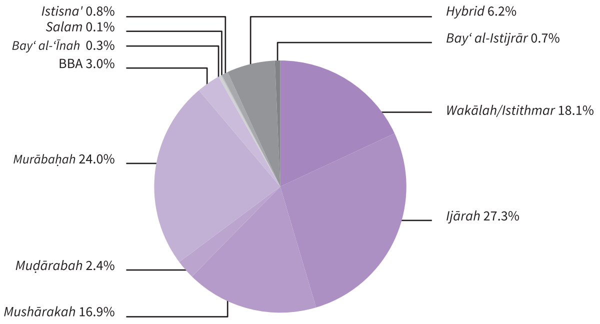
Chart 3.4.6
Global New *Sukūk* Issuances by Structure (11M15)



Source: Zawya, Bloomberg, IFSB

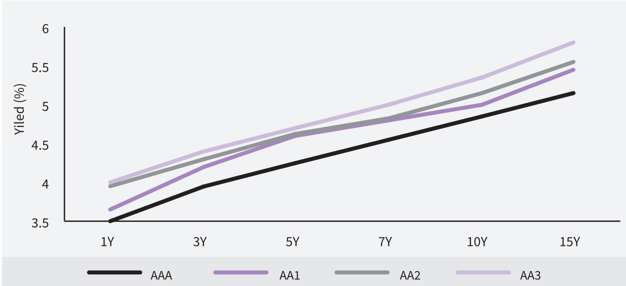
[213] See Bank Negara Malaysia (2010), Sharīʻah Resolutions in Islamic Finance, 2nd edition, October.

Chart 3.4.7
Global *Sukūk* Outstanding by Structure (11M15)



Source: Zawya, Bloomberg, IFSB.

Chart 3.4.8
Bloomberg–AIBIM Malaysia Corporate *Sukūk* Benchmark Curve



**As of 9 December 2015.*
Source: Bloomberg, IFSB.

Sukūk Ratings/Pricing Benchmarks

Sukūk instruments are now actively rated by all major international rating agencies, including Standard & Poor's, Fitch and Moody's (see Table 3.4.1). In addition, a number of domestic rating agencies in different jurisdictions – for example, Malaysia since 2004 and more recently Pakistan – have been rating domestic *sukūk* issuances.

However, the progress on *sukūk* pricing benchmarks is contained and needs more rigorous efforts, starting from the development of an active capital market where issuances are available across a wide range of tenures, including short-, medium- and long-term maturities. This is particularly relevant for the GCC region, where capital market activities are limited and the banking channel is the main source of funding. The availability of *sukūk* pricing benchmarks is critical, since these serve as initial price guidance for prospective issuers across a wide range of maturities. The need is more profound for corporate issuances in the domestic market that need clarity on the appropriate funding costs for raising funds through *sukūk*.

The progress has been exemplary in Malaysia, where an active *sukūk* issuance programme by the government across a wide range of tenures (ranging from short three-month Treasury bills to the long-term 30-year government financing *sukūk*) has facilitated a pricing benchmark curve.[214] In addition, Malaysia is one of the few countries that has benchmark curves for corporate *sukūk* across different ratings and maturities (see Chart 3.4.8). In the GCC, the *sukūk* market is gradually catching up, although, in 2015, there was a noticeable lack of longer-term maturity issuances. The popular maturities for issuances in the GCC are for five years and ten years, by both sovereigns and corporates alike. For longer-term developmental and infrastructure expenditures, both sovereign and corporate issuers may consider venturing into longer-maturity *sukūk* issuances that can reduce the need for regular refinancing and its associated risks.

Summary and Challenges

In summary, *sukūk* have gained widespread acceptance by issuers and investors globally, from both OIC and non-OIC member states alike. However, there remain some persistent challenges which need to be addressed to further expand *sukūk's* role as a viable and alternative fund-raising instrument that supports broader macroeconomic objectives. In particular, the instrument continues to demand premium pricing on issuance when compared with bonds; this could potentially be discouraging some issuers from pursuing *sukūk* as it will translate into higher funding costs. Some jurisdictions have attempted to address this challenge by providing incentives on *sukūk* issuances, such as tax and stamp duty exemptions, in order to encourage issuers to utilise *sukūk*.

Meanwhile, international *sukūk* issuances continue to be oversubscribed many times, indicating a gap between the demand and supply of instruments. *Sukūk* are widely demanded by a broad array of investors, including: (a) Islamic banks for capital and liquidity management purposes; (b) *takāful* operators for steady Sharī'ah-compliant returns on portfolios; (c) fund managers for offering Sharī'ah-compliant fixed-income funds to clients; and (d) others, including sovereign wealth funds, pension funds, conventional financial institutions and other investors, attracted by the comparatively higher returns on *sukūk*, as well as by the opportunity to diversify investments. An emerging risk is the potential shortage of high-quality collateral to meet heightened regulatory requirements (i.e. Basel III, IFSB-15). This puts pressure on the demand for highly rated *sukūk* instruments which are likely to be held by IIFS until maturity.

From an investor protection perspective, disclosure of financial risks and clarity on *sukūk* structures is another area of consideration. This was particularly a challenge during the initial years of the *sukūk* market, when the first *sukūk* defaults led to lengthy legal proceedings

[214] However, the decision by BNM in 2015 to halt its short-term *sukūk* programme likely removes an important component of the country's benchmark *sukūk* yield curve.

on the interpretations of *sukūk* contracts concerning the rights of *sukūk* investors and responsibilities of the *sukūk* originators (e.g. the East Cameron Gas *sukūk* default). Inadequate disclosure puts investors at risk of buying products or services that are much riskier than anticipated, and there could be a mismatch between the risk appetite of the investor and the risk embedded in the product. This issue also involves the need for much better understanding by investors of *sukūk* structures, particularly of aspects related to asset-backed versus asset-based *sukūk* that determine the recourse available to them during instances of default.

Some concerns in the conventional bond market[215] have also been raised regarding the illiquidity of bonds used as collateral during times of stress, and these could lead to performance issues of bonds as per investors' expectations. Furthermore, during periods of a low interest rate environment in global markets, there are fears of a shift from a principally fund-raising market (bond market) to an agency market (banks, financial intermediaries, etc.) which leads to decreased liquidity in the bond market. Lack of liquidity for corporate bonds harms issuers and investors alike, with attendant consequences for dealers and trading venues. In general, such concerns are also applicable for the *sukūk* market.

Stakeholders need to continue consolidating legal frameworks in order to reduce both issuers' and investors' unease (if any) on the resulting *sukūk* resolution should a default occur in a foreign jurisdiction. This, in turn, should enable further confidence in cross-border *sukūk* issuances and investments globally. A lot of progress has been made in terms of ratings of instruments, harmonised *sukūk* structures (e.g. *ijārah sukūk*) and greater listings of international *sukūk* for cross-border investors. However, more effort is needed to introduce regular issuance programmes to create benchmark pricing yield curves that can provide the necessary guidance to both issuers and investors. These regular and, consequently, increasingly more frequent *sukūk* issuances could also alleviate the "buy and hold-until-maturity" attitude of *sukūk* investors, thus leading to increased trading in secondary markets.

Overall, despite a weakened global capital market sentiment, *sukūk* have performed resiliently, with issuances oversubscribed and very low instances of default since the sector's inception, which is traceable to as early as 1990. In 2015, primary *sukūk* issuances have proportionately adopted more partnership-based Sharī'ah contract structures, although there remain some concerns regarding the use of purchase undertakings and liquidity facilities by some obligors. This is an area which needs more detailed study to decipher the potential systemic risks should certain events lead to defaults in *sukūk*. Of particular importance in this study would be the inherent and legally enforceable structures adopted by the issuers, and whether investors have recourse to the underlying assets of the *sukūk*. This study also needs to touch upon the macrofinancial linkages of the global *sukūk* market with other sectors in both the Islamic financial services industry and other broader sectors of the global economy. Such analysis holds more critical relevance for jurisdictions where *sukūk* have become the primary instrument of fund-raising in the capital markets (e.g. Malaysia, where more than half of all funds [53% in 1H15] raised in the debt market are through *sukūk*).

(b) Islamic equity and funds market

Since its inception in the 1990s, Islamic equity indices and funds have established a presence in global markets; however, the stages of development vary across different jurisdictions. The publicly available Islamic funds are concentrated in just two domiciles: Saudi Arabia (40%) and Malaysia (28%), as measured by assets under management.[216] In addition to these two, three non-OIC member jurisdictions complete the list of the top five jurisdictions for Islamic funds by AuM: Jersey (8%), the United States (7%) and Luxembourg (4%). Collectively, the top five jurisdictions as domiciles account for 87% of the global Islamic funds market.

A number of key Islamic finance domiciles that are important contributors to the global Islamic banking assets (e.g. Kuwait, Qatar, the UAE, Bangladesh and Pakistan) host very small shares of the global Islamic funds industry. This is due mainly to limited capital market activities in these jurisdictions, where the banking channel remains the main source of funds. In some other domiciles, although they host a thriving conventional capital and stock market (e.g. the Karachi Stock Exchange in Pakistan was one of the best-performing bourses in the world in 2014), the concept of Sharī'ah-compliant indices and Islamic funds has recently been introduced, and is expected to gradually gain traction in the next few years. For instance, Islamic indices were first introduced in Bangladesh in 2014; recently, in November 2015, the Asian Development Bank approved a USD250 million loan to strengthen the country's capital markets in order to boost institutional investor demand while broadening the supply of financial instruments, including *sukūk*.

In the comparatively more developed capital markets, progress and advancements have ventured into more innovative opportunities, including Sharī'ah-compliant venture capital and crowdfunding platforms. For instance, in Malaysia, the capital markets regulator, the Securities Commission Malaysia, has already established

[215] IOSCO (2015), *A Survey of Securities Market Risk Trends 2015.*
[216] See Chart 1.3.2.7 in Chapter 1.

regulatory guidelines (released February 2015) to facilitate crowdfunding – both Islamic and conventional. In the same year, the Commission gave approval to a total of six equity crowdfunding operators, one of which has proposed to operate a Sharī'ah-compliant equity crowdfunding platform. Similarly, in Singapore, a Sharī'ah-compliant internet-based venture capital platform was established in March 2014; within a year, it had raised SGD2.5 million (USD1.8 million) to finance buyers of affordable new homes in Indonesia.

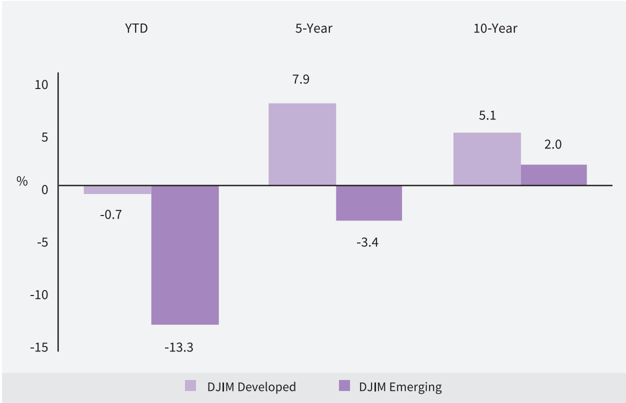
Overall, the opportunities to expand Islamic funds in diverse markets, and to expand Islamic funds' investments over a wider geographical focus, are substantially facilitated by the availability of Islamic indices. The world's major financial index providers (e.g. S&P, Dow Jones, FTSE, MSCI, etc.) all provide broad-market, blue-chip, fixed-income, and strategy and thematic indices for Sharī'ah-compliant investments in a vast number of stock markets around the world.

Equity Indices Performance Analysis

The Sharī'ah-compliant stocks are subsets of the broader global stock-market securities[217] and, hence, the Islamic benchmark indices are also subject to volatilities on account of global macroeconomic events. In this regard, the IMF in its World Economic Outlook of January 2016 projected a marginally lower global growth in 2015 and warned of a shift in risks from the advanced economies to the developing economies and emerging markets. This phenomenon is evident when analysing the returns performances, using the Dow Jones Islamic Market indices as proxies, of the developed markets vis-à-vis the emerging markets. The DJIM Emerging Markets Index returned sharply negative (–13.3%) in 11M15, which is in contrast to the (–0.7%) of the DJIM Developed Markets Index (see Chart 3.4.9). The conventional DJ indices also witnessed similar trends: the DJ Emerging Markets Index returned –11.74%, while the DJ Developed Markets Index returned –3.13%.

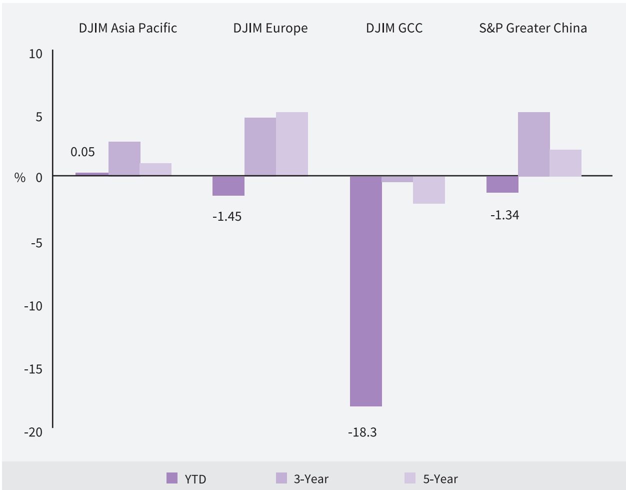
By region, the equity markets of the GCC were the worst affected in 2015 on account of persistently low oil prices, widening budget deficits, regional conflicts, political challenges and, in general, weaker business confidence (see Chart 3.4.10). The DJIM GCC returned –18.3% in 11M15, which is almost similar to DJ GCC's –17.1%; the DJIM Europe returned –1.45%, DJIM Asia Pacific 0.05% and the S&P Greater China Sharī'ah –1.34%. In general, the stock markets globally have witnessed negative returns in 2015, and this was equally experienced by both the Islamic and conventional benchmark equity indices.

Chart 3.4.9
Price Returns of DJIM Developed Markets and DJIM Emerging Markets Indices (11M15)



Source: Bloomberg, IFSB.

Chart 3.4.10
Price Returns of DJIM/S&P Markets Indices by Region (11M15)



Source: Bloomberg, IFSB

Islamic Funds Performance Analysis

The negative returns in the stock markets have, in turn, translated into negative returns for the Islamic funds market. In 11M15, the returns of Islamic funds across all asset classes were, on average, negative, with the only two exceptions being the fixed-income/*sukūk* and money market asset classes (see Chart 3.4.11). The fixed-income/*sukūk* asset class generated a return of 3.28%, slightly lower than the 3.57% return recorded last year, mainly on account of an upward momentum in investors' required yield in 2015, which has contributed towards lower valuations of outstanding instruments, particularly those with fixed returns. This notion is supported by the returns on money market funds, which – at 2.16% – are higher than the 1.53% generated in 2014; this indicates

[217] As was discussed in detail in Chapter 1.

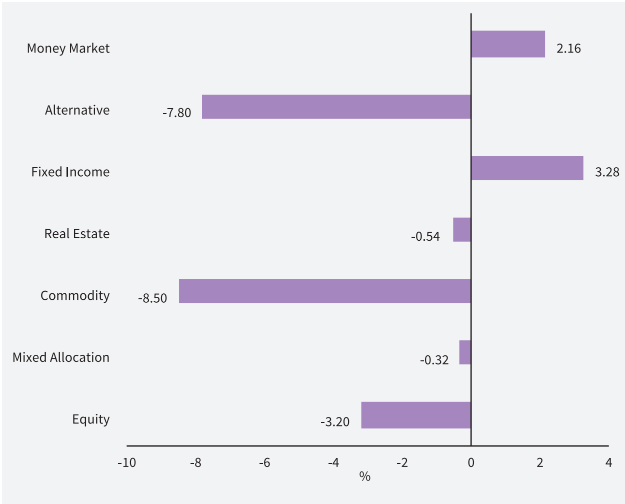
that rates in general have increased in 2015 as compared to the low-rate environment in 2014 when the US Federal Reserve was still conducting its gradual tapering of monthly bond-buying programme.

In contrast, commodity funds was the worst-performing asset class, posting –8.5% returns, pulled down by the persistent low prices of commodities and energy products in 2015. The prospect of a worsening performance of commodity funds was already indicated in last year's stability report, which reported double-digit declines recorded in the futures markets for energy, agricultural products and precious metals. The returns on other asset classes were as follows: alternative –7.8%, equity –3.2%, real estate –0.54% and mixed allocation –0.32%. The performance in 2015 is in sharp contrast to previous years, when all asset classes in the Islamic funds market had posted positive returns (see Chart 3.4.12). The only exception was commodity funds, which had also posted negative returns in 2013.

Geographically, the returns were subdued across most markets, particularly in the emerging markets, the GCC, and the Middle East and North Africa (see Chart 3.4.13). Islamic funds having a geographical focus on the GCC returned, on average, –6.63%; BRIC countries returned –2.08%; and Global –0.65%. The European geographical focus fared comparatively better, with a 5.32% average return, as well as the United States with 1.86%.

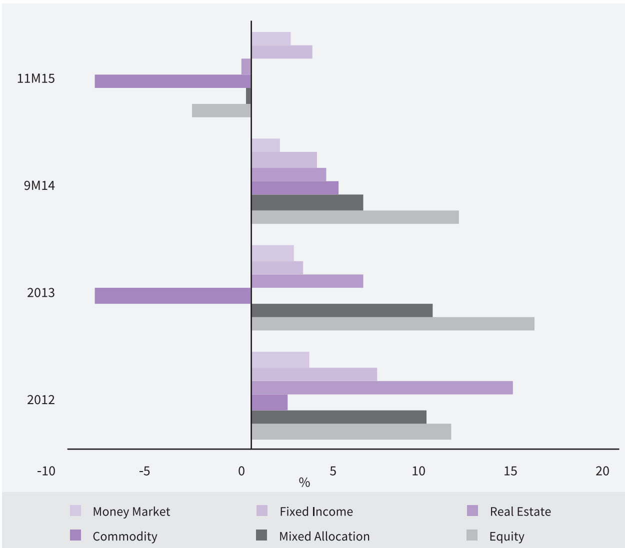
In terms of scale and size of Islamic funds, there were some improvements in 2015 compared to the previous year (see Chart 3.4.14): the number of funds with AuM of between USD25 million and USD95 million increased to 239 (2014: 233); with AuM of between USD5 million and USD25 million increased to 404 (2014: 304); and with AuM of less than USD5 million reduced to 460 (2014: 501). However, the average size of Islamic funds is still small, with nearly 71% of the funds having AuM of less than USD25 million. This is due mostly to the retail customer base of Islamic funds and a largely untapped institutional investor segment comprising sovereign wealth funds, pension funds, *waqf* funds and private banks. The industry also remains geographically concentrated, as nearly 68% of AuM are domiciled in two jurisdictions, Saudi Arabia and Malaysia, and the same two jurisdictions are the geographical focus for 54.5% of the global Islamic funds' assets (as was analysed in Chapter 1).

Chart 3.4.11
Returns of Islamic Funds by Asset Type (11M15)



Source: Zawya, Bloomberg, IFSB.

Chart 3.4.12
Historical Returns of Islamic Funds by Asset Type

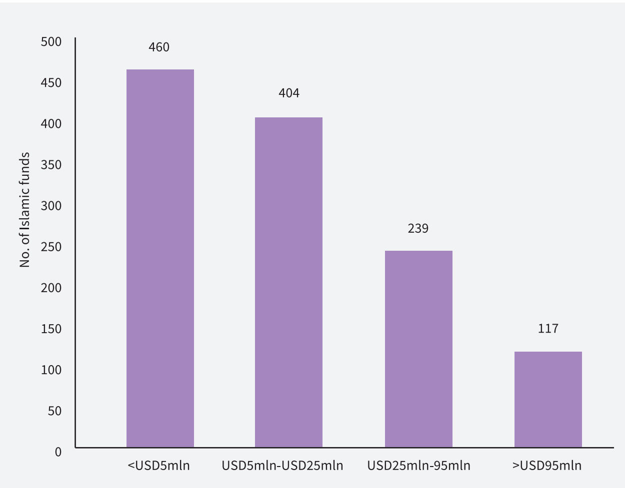


Source: Zawya, Bloomberg, IFSB.

Chart 3.4.13
Returns of Islamic Funds by Geographical Focus (11M15)

Source: Zawya, Bloomberg, IFSB

Chart 3.4.14
Number of Islamic Funds by Asset Size (11M15)



Source: Zawya, Bloomberg, IFSB.

Summary and Outlook

The performance of the global Islamic equity indices and funds market has been impacted by the world's macroeconomic developments in 2015, ranging from lower-than-forecasted economic growth, falling commodity prices, expectations of interest rate increases in the US, fresh rounds of sell-offs of emerging market assets, combined with currency depreciations and socio-political tensions across the Middle East, Central Asia and, to some extent, in Europe. The industry remains densely concentrated in a select few countries: the top five domiciles account for 87% of the global Islamic funds AuM. Similarly, the top two domiciles account for almost 55% of the geographical focus of the global Islamic funds' AuM. There have been some efforts initiated to develop Islamic indices, and subsequently Islamic funds, in countries that are traditionally key Islamic banking domiciles, but have limited traction in the Islamic equity and funds markets (e.g. Pakistan, Bangladesh, Kuwait, Qatar, the UAE, etc).

Going forward, the industry needs to achieve greater geographical diversification across jurisdictions and to expand its volume of AuM. Furthermore, it needs to amass greater scale by tapping into the pool of institutional investors, particularly those with a religious focus,[218] by leveraging on the Sharī'ah-compliant focus of Islamic funds offerings. The regulatory authorities need to do their part by providing clear guidelines to fund managers on managing Islamic funds, particularly on the transparency of practices in Islamic funds (e.g. when dealing with purification of tainted income, change in Sharī'ah compliance status of invested securities, and the overall Sharī'ah screening methodology used by the fund manager). In this regard, the IFSB has embarked upon preparing a standard to address the disclosure requirements for Islamic capital market products (as discussed in Chapter 2).

3.5 OVERALL SUMMARY

The global IFSI has undergone a challenging period in 2015 and, amid increased downside growth expectations in the world economy, is expected to face further risks in 2016.

Islamic Banking

The Islamic banking sector, which accounts for almost 80% of the global IFSI, remains concentrated in a few Middle Eastern and Asian countries that are classified as commodity-exporting and/or emerging markets. These jurisdictions are particularly susceptible to the current global macroeconomic turbulence (e.g. commodity prices, exchange rates, etc.), and their domestic banking sectors (both Islamic and conventional) have cautious outlooks from a liquidity and earnings perspective. Major international ratings agencies caution against risks of slower deposit growth going forward due to relatively weaker liquidity conditions, while asset quality is also at risk of deterioration in line with the economic slowdown.

In general, the Islamic banking sector (based on a sample of 59 major banks across 11 countries) appears to be sufficiently capitalised above minimum regulatory

[218] For example, the Employees Provident Fund of Malaysia has announced that it will start offering Sharī'ah-compliant pension accounts to its members starting January 2017.

requirements while maintaining non-performing financing at rates much lower than those witnessed during the financial crisis years. Exposures to the real estate sector, which was largely responsible for the build-up of impaired financing in the financial books during the financial crisis years, have also been materially scaled down. An area of concern, however, is the short-term liquidity health of Islamic banks, as the three-month assets-to-liabilities ratio has deteriorated since that reported in the previous stability report. This aspect is particularly concerning for jurisdictions with no active Sharī'ah-compliant interbank and/or other Sharī'ah-compliant short-term liquidity arrangements. Meanwhile, pressures on profitability and returns have also begun to build up in 2015 and moving into 2016, contributed in part by the global monetary environment where another tide of low interest rate environment is being experienced, including a regime of negative rates, in some markets. This has been combined with expectations of downward revisions in pledged collateral values and a general deterioration in asset quality in line with the weak growth forecasts of economies going forward.

In the light of such conditions, it is critical for the Islamic banking sector to diversify its revenue pools and reduce concentration risks (e.g. dependence on public-sector deposits and financing, exposures in sensitive sectors – oil and gas, and real estate) to sustain long-term resilience. Policymakers need to, and to require Islamic banks to, conduct robust stress tests to pre-emptively identify areas of growing vulnerability and initiate any necessary remedial actions and policies without delay. This may also include providing the necessary infrastructure to manage impending risks and vulnerabilities (e.g. Sharī'ah-compliant liquidity mechanisms and instruments for managing liquidity). Overall, conditions vary significantly between countries, and each jurisdiction is exposed to its unique set of domestic conditions that will significantly affect the Islamic banking sector's performance in 2016 and beyond.

Islamic Capital Markets

Despite weak investor sentiments in the global capital markets, the demand for new *sukūk* issued in the primary market has remained resolute and most of the international *sukūk* instruments issued in 2015 have been oversubscribed many times. This indicates a continued gap between the demand and supply of *sukūk*. Given the evolving global regulatory requirements (i.e. Basel III, IFSB-15), there is likely to be increased demand going forward for highly rated *sukūk* instruments to meet regulatory requirements and these are likely to be held by IIFS until maturity, thus potentially further widening the demand-and-supply gap while restricting secondary market activity.

A persistent anomaly in the *sukūk* market has been the premium pricing of new issuances compared to identical bonds. While premium pricing offers incentives in the form of higher returns to investors, it also represents higher funding cost for issuers, thus potentially discouraging some issuers from issuing *sukūk*. In terms of investors' yield expectations in the secondary markets, there is no clear and identifiable pattern in 2015 to suggest that *sukūk* always trade at comparatively higher secondary market yields to identical bonds.

In general, the *sukūk* market has sustained resilience and there have been no instances of default since 2010; as of November 2015, out of almost USD1.12 trillion worth of funds raised by *sukūk* to date, only USD1.85 billion (or 0.17%) of the total issuances volume has defaulted. Going forward, regulatory focus needs to continue in the area of legal frameworks consolidation in order to reduce both issuers' and investors' unease (if any) on the resulting *sukūk* resolution should a default occur in a foreign jurisdiction. This, in turn, should enable further confidence in cross-border *sukūk* issuances and investments globally. Efforts also need to continue in introducing regular issuance programmes to create benchmark pricing yield curves that can provide necessary guidance to both issuers and investors. These regular, and consequently increasingly frequent, *sukūk* issuances could also alleviate the "buy-and-hold-until-maturity" attitude of *sukūk* investors, thus leading to increased trading in secondary markets.

In the Islamic funds segment of capital markets, the sector remains densely concentrated with the top five domiciles accounting for 87% of the global Islamic funds' AuM. Similarly, the top two domiciles account for almost 55% of the geographical focus of the global Islamic funds' AuM. The average size of Islamic funds is also small, with nearly 71% of the funds having AuM of less than USD25 million. This is due in particular to the retail customer base of Islamic funds and a largely untapped institutional investor segment comprising sovereign wealth funds, pension funds, *waqf* funds and private banks.

Going forward, Islamic funds need to amass greater scale by tapping into the pool of institutional investors, particularly those with a religious focus, by leveraging on the Sharī'ah-compliant focus of Islamic funds offerings. The regulatory authorities need to do their part by providing clear guidelines to fund managers on managing Islamic funds, particularly on the transparency of practices in Islamic funds (e.g. when dealing with purification of tainted income, change in Sharī'ah compliance status of invested securities, and the overall Sharī'ah screening methodology used by the fund manager). In this regard, the IFSB has embarked upon preparing a standard to address the disclosure requirements for Islamic capital market products (as discussed in Chapter 2).

Takāful

Assessing the resilience of the *takāful* sector is difficult because of the limited data available, and the very different characteristics of family and general *takāful*. Much family *takāful* is investment linked and shares many characteristics with the Islamic funds industry. It is concentrated in a relatively few jurisdictions, and is at present affected by low investment returns. However, investment risks are largely passed on to the contributors. The general *takāful* sector is more affected by the global insurance cycle, which is currently in a soft phase, implying that pricing may be on the low side. It is also affected by low investment returns, which cannot be passed on to contributors in the same direct way.

Nevertheless, the *takāful* sector appears relatively robust. Its position has been enhanced by advances in solvency regulation in key markets, especially in the GCC and East Asia regions, and, for the general *takāful* industry in particular, by the gradual expansion of compulsory insurance requirements in areas such as motor and health. In principle, there should be scope for expansion in markets that in general have low insurance penetration. However, the small size of many *takāful* undertakings is a source of concern, and it is likely that one consequence of improved regulation will be consolidation of the sector in some countries. On the financing side, investment opportunities for the *takāful* sector continue to be constrained by the availability of appropriate Sharī'ah-compliant investment products, which in turn affects the returns that *takāful* firms are able to achieve. In this respect, a supply of high-quality, longer-term *sukūk* and access to equity markets become more important.

4.0 EMERGING ISSUES IN ISLAMIC FINANCE

4.1 CROSS-SECTORAL LINKS BETWEEN VARIOUS SECTORS OF THE IFSI AND THE IMPLICATIONS FOR SYSTEMIC STABILITY[219]

4.1.1 A Preliminary Note on Terminology

The analysis of cross-sectoral links requires the definition of the term "sector". Unfortunately, the term is used differently by various authors and institutions. This report follows a convention in Islamic finance and distinguishes on a relatively high level of aggregation between:

- the banking sector, with its stand-alone Islamic commercial banks and Islamic windows of conventional banks as the main actors that accept deposits and PSIA from the general public and provide various forms of Sharī'ah-compliant financings to households, private businesses and the public sector;

- the capital market for Sharī'ah-compliant securities, which can be:
  - equity shares of companies that satisfy Sharī'ah compliance criteria (Sharī'ah-compliant stocks),
  - *sukūk*, which are primarily debt securities[220] but can occasionally also be equity-like securities,

  with a wide range of market players as issuers or sellers on the supply side (in particular, sovereigns and private firms, including Islamic banks), as buyers on the demand side (in particular, Islamic and conventional banks and *takāful* operators), and as intermediaries in-between (in particular, broker–dealers, investment banks, funds);

- the funds sector, where Islamic funds and other non-depository Islamic financial intermediaries such as investment banks and finance companies provide financings and asset management services mainly for institutional investors (such as pension funds, *takāful* operators, endowments and *awqāf*, and family offices) and offer collective investment schemes for retail clients; and

- the *takāful* sector, with two different product lines – protection products (in demand by private households, firms and Islamic banks for financed assets and individuals) and capital formation or savings products (in demand particularly by private households), provided by stand-alone *takāful* operators or *takāful* windows of conventional insurance companies.

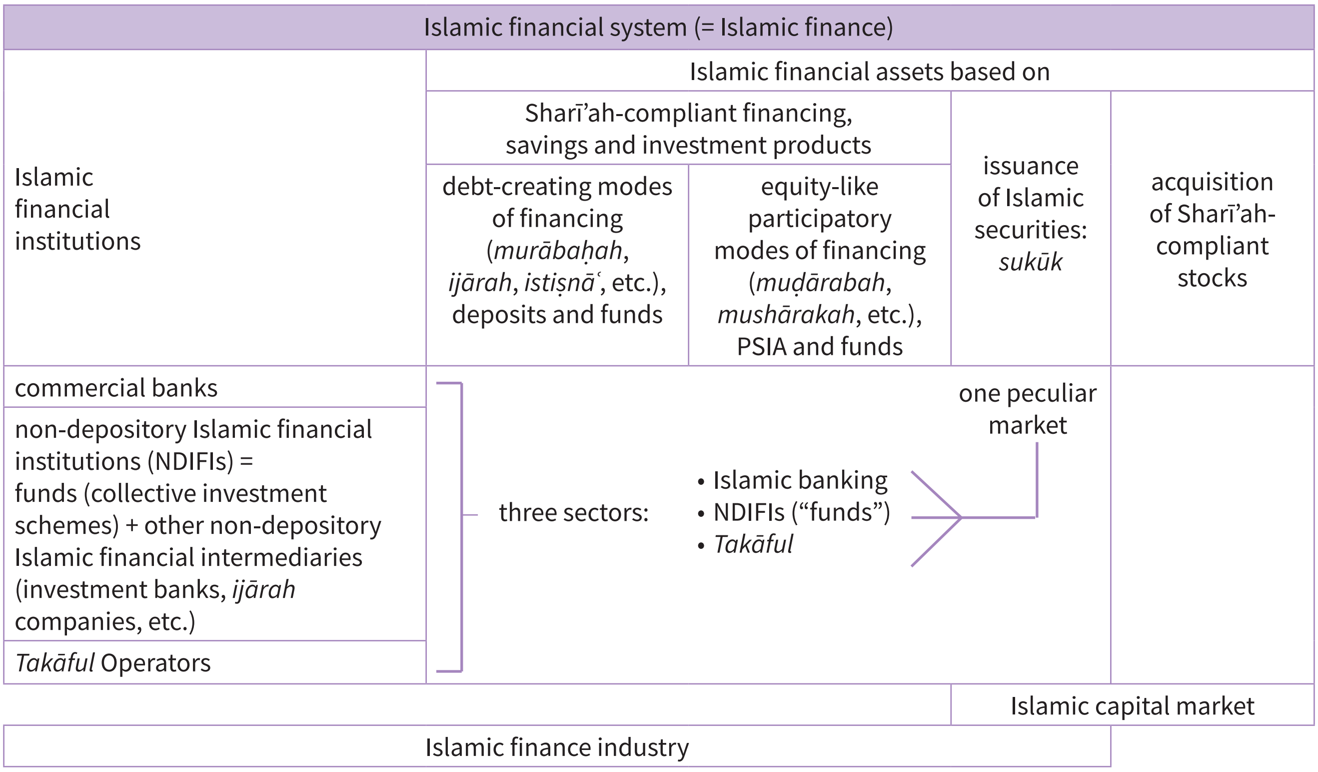
It should be noticed that the term "sector" was only used for banking, funds and other non-depository financial intermediaries, and *takāful* – that is, for financial institutions. The fourth component of the Islamic finance system (or, in short, of Islamic finance) is different from the three sectors in so far as it is not defined by actors but by objects of transactions (stocks and *sukūk*). The actors in this financial market come from all three financial sectors. Chart 4.1.1.1 summarises the terminology. One term and its definition require a further explanation – namely, "Islamic finance industry": it comprises the three groups of Islamic financial institutions and their Sharī'ah-compliant financing, savings and investment products plus the market for *sukūk*. It excludes the market for Sharī'ah-compliant stocks.

There are good reasons for this distinction between two major groups of Islamic finance assets, namely: (1) those assets that are either created by (debt-creating or equity-like) financing activities or specifically designed as Islamic securities (*sukūk*); and (2) Sharī'ah-compliant stocks. Both groups of assets meet Sharī'ah requirements and therefore are classified as Islamic finance assets and objects of transactions of Islamic financial institutions. However, there is a fundamental difference between assets created by Islamic modes of financing and *sukūk*, on the one hand, and Sharī'ah-compliant stocks, on the other hand, which justifies the exclusion of the latter from the Islamic finance industry. Sharī'ah-compliant stocks have (at least until now) not been "manufactured" specifically to meet Sharī'ah requirements. They are (maybe with a very few exceptions) not alternatives for but actually are conventional shares not specifically structured by the issuers to meet Sharī'ah compliance requirements. Instead, they are deemed Sharī'ah-compliant by Islamic investors because the core business of the share-issuing company is not ḥarām and the company's interest-based transactions (as reflected by some financial ratios) do not exceed certain threshold levels set by Sharī'ah authorities.

[119] The scope of this section is limited to cross-sectoral links on an aggregated basis at a jurisdictional level. Hence, it does not consider, for instance, institutional-level links, particularly those involving financial groups and conglomerates that may have system-wide implications. Some of these aspects will be addressed in the upcoming IFSB Working Paper on this subject.

[220] *Sukūk* are Sharī'ah-compliant debt securities because the underlying Sharī'ah contract is either a debt-creating contract (such as *murābaḥah*, *istiṣnā'* or *ijārah*) or a partnership contract (such as *muḍārabah* or *mushārakah*) that is not applied in its original equity-like form but transformed by third-party guarantees and incentive fees into a functional equivalent of a fixed-income debt-like instrument.

Chart 4.1.1.1
Definition of Islamic Finance Sectors



In so far as Sharī'ah-compliant stocks have not been specifically manufactured but are a subset of the universe of conventional stocks, they are neither institutions nor products of the Islamic finance industry; they are Islamic financial assets and constitute a component of the Islamic finance system. This difference is also reflected in estimates of the size of the Islamic finance industry: the common method is to aggregate the total assets of Islamic financial institutions (which predominantly result from Islamic modes of financing but may include some holdings of Sharī'ah-compliant stocks) and to add the value of outstanding *sukūk*, but not to add the market capitalisation of Sharī'ah-compliant stocks (which may be more than ten times the size of the commonly estimated USD1800 billion of the Islamic finance industry in 2014).[221] Nevertheless, for an analysis of intersectoral links the stock market must not be ignored, since stock prices have an impact on all Islamic financial institutions that hold Sharī'ah-compliant stocks.

4.1.2 The Flow of Funds between Islamic Finance Sectors and the Size of the Industry

The main sectors of Islamic finance are subdivided into groups for which – at least some – specific data are available.[222]

- Islamic banking is sometimes subdivided into commercial, investment, specialised and wholesale banks. Although all these institutions are called banks, not all are deposit taking, which is a very important feature from a stability perspective. As investment, specialised and wholesale banks usually do not take deposits from the general public they should better be classified as non-depository financial intermediaries.
- Islamic non-depository financial intermediaries comprise non-depository banks, funds and other intermediaries, which are further subdivided as follows:
  - by the type of assets managed by funds into equity, money market, *sukūk*, mixed, real estate, commodity and other funds; and
  - by the focus of the business of the other Islamic financial intermediaries into financing companies, insurance, investment firms and funds,[223] *muḍārabah* companies (Pakistan), leasing companies, mortgage and real estate firms, brokers and traders.
  - *takāful* undertakings are classified by the lines of business: respectively, the licence of the operator as Life ("Family"), General, and Composite *takāful* and *retakāful*.

[221] The Dow Jones Islamic Market World Index that tracks Sharī'ah-compliant stocks traded globally had a market capitalisation of USD21,373 billion by the end of January 2016 (which is 45% of the capitalisation of the Dow Jones Global Index); see www.djindexes.com/mdsidx/downloads/fact_info/Dow_Jones_Islamic_Market_World_Index_Fact_Sheet.pdf and www.djindexes.com/mdsidx/downloads/fact_info/Dow_Jones_Global_Indices_Fact_Sheet.pdf (accessed 7 February 2016).

[222] The classifications and figures in this chapter are based on the ICD Thomson Reuters Islamic Finance Development Report 2015.

[223] There seems to be an overlap between the subcategories "insurance" and "*takāful*" and between "investment firms and funds" and "funds". The second overlap is significant, as the latter subcategory is similar in size to the assets under management of Islamic funds. The overlaps and the resulting ambiguities may be due to different classification schemes of providers of primary data.

The intensity of the links between sectors depends on the relative size of the different subsectors. Chart 4.1.2.1 provides an overview of the quantitative structure of the Islamic finance industry. The industry is dominated by Islamic banking, with an average share of 74% of total industry assets plus *sukūk* outstanding (including short-term liquidity *sukūk*), or 89% of total assets of Islamic financial institutions (excluding *sukūk*).[224]

Conventional financial institutions are mentioned in the chart as a player in the Islamic finance industry, but reliable data on the quantitative dimension of this market participant are not available. However, it is well known that conventional financial institutions are involved in the *sukūk* markets, and it is often reported that they find *sukūk* very suitable for a diversification of portfolios. But when it comes to data, only fractional evidence is at hand.

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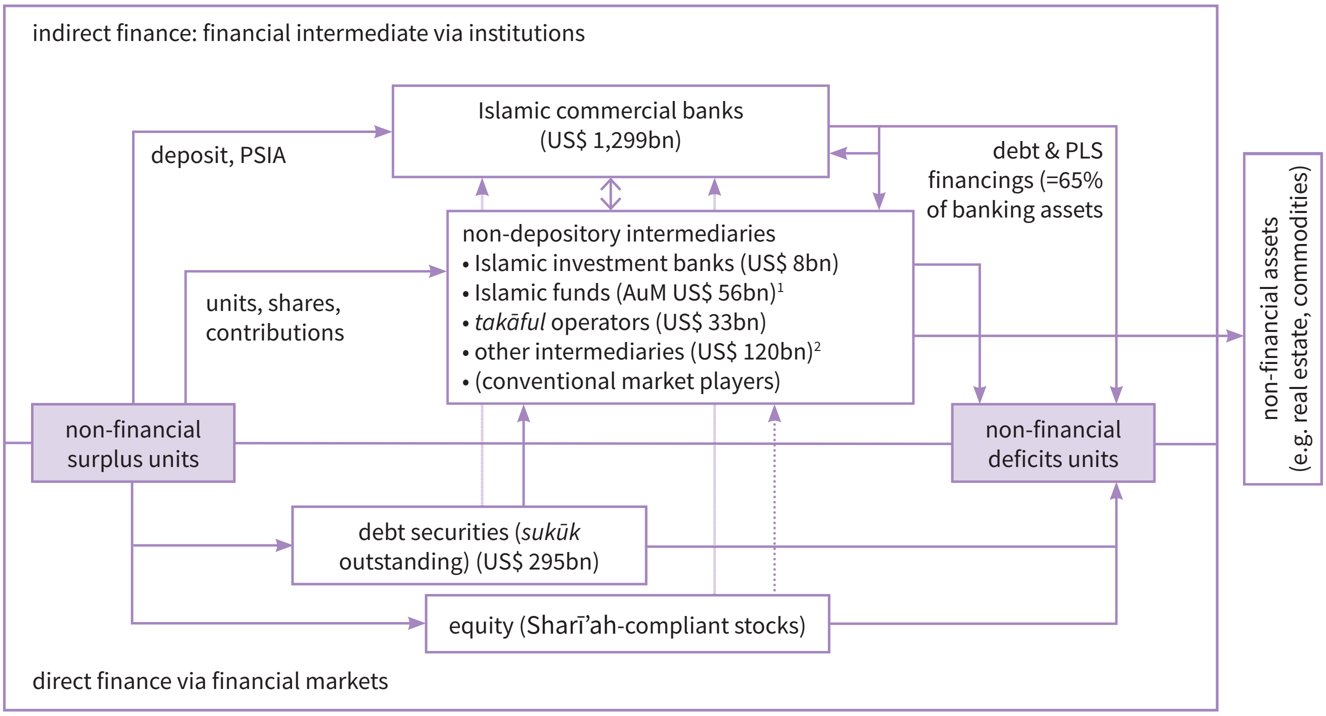
Chart 4.1.2.1
Assets of Financial Institutions, *Sukūk* and Flow of Funds in Islamic Finance



[1] AuM USDbn: equity 24, money market 22, *sukūk* 4, mixed assets 3, real estate 2, commodities 0.2, others 0.1.
[2] Assets USDbn: specialised banks 30, wholesale banks 6, OIFIs (financing companies, investment firms, others) 84.
Notes: (1) Total assets 2014 of commercial banks, non-depository intermediaries, *sukūk* outstanding: USD1814bn. (2) non-financial surplus/deficit units = (domestic and foreign) households, businesses and governments. Source: Data excerpted from ICD Thomson Reuters Islamic Finance Development Report 2015.

A summary of data on the composition of the assets of the Islamic finance industry excerpted from the ICD Thomson Reuters Islamic Finance Development Report 2015 is presented in Table 4.1.2.1.

[224] The size of the industry may be overestimated somewhat because of a double counting of *sukūk* which are held by Islamic financial institutions and included in their total assets; see section 1.1 in Chapter 1. It should also be noted that the size of the *takāful* sector is measured here by its assets, while it was measured by annual contributions in section 1.4. However, annual premiums in conventional insurance and respectively contributions in *takāful*, are more adequate for comparisons within the insurance/*takāful* sector.

Table 4.1.2.1
Structure of Assets of the Islamic Finance Industry

	Global	Malay-sia	Saudi	Iran	UAE	Kuwait	Qatar	Bahrain	Turkey	Indone-sia	Bangla-desh	Other
Islamic banks	74.2%	41.9%	78.8%	95.2%	78.8%	89.9%	82.8%	93.9%	82.8%	53.8%	97.1%	70.8%
- commercial	71.6%											
- investment	0.4%						2.5%	5.1%				
- specialised	1.7%											
- wholesale	0.3%											
Takāful	1.8%	2.0%	3.0%	2.4%	1.1%	0.1%	0.4%	0.6%	0.0%	0.0%	2.6%	0.4%
Sukūk	16.3%	40.3%	11.4%	0.0%	16.7%	0.8%	15.7%	4.9%	17.2%	17.2%	0.0%	9.8%
OIFI	4.6%	11.6%	1.2%	2.0%	3.2%	7.8%	0.9%	0.6%	0.0%	0.0%	0.3%	9.1%
- investment firms and funds	2.9%											
- financing companies	1.1%											
- real estate	0.3%											
- others	0.3%											
Funds	3.1%	4.3%	5.7%	0.4%	0.2%	1.3%	0.3%	0.0%	0.0%	0.0%	0.0%	9.9%
- equity	1.3%											
- money market	1.2%											
- *sukūk*	0.2%											
- others	0.3%											
Islamic finance industry	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Islamic finance industry US$ bn	1,814.1	415.4	413.0	345.5	161.4	97.6	86.5	72.8	53.9	53.9	23.2	104.5

Note: This chart indicates the breakdown of Islamic financial assets by sector/institutions (e.g. 71.6% of global Islamic finance assets are held by Islamic commercial banks).
Source: Data excerpted from ICD Thomson Reuters Islamic Finance Development Report 2015.

A few observations shall be highlighted.

- "Islamic banking" is clearly dominated by commercial banks. Their business model is based on the acceptance of deposits and PSIA on the liability side and the creation of assets (claims) from Sharī'ah-compliant forms of predominantly debt-creating financing on the asset side. Investment banks, specialised banks and wholesale banks are classified in conventional finance as non-depository financial intermediaries: they may provide similar forms of financings as commercial banks, but they do not accept deposits or investment accounts from the general public. Their funding typically comes from the capital market or other financial institutions, but sometimes also from private placements or public sources. Table 4.1.2.1 lists a number of non-commercial Islamic banks. They are very small in general, but quite visible as investment banks in Qatar and Bahrain.

- The aggregate share of non-depository banking intermediaries in the total assets of Islamic banks amounts to USD44 billion – which is more than the total assets of *takāful* operators – or 3.3% of total Islamic banking assets. The table also indicates that available data are very fragmentary.

- The table shows very significant differences in the relative weight of Islamic commercial banking for the Islamic finance industries of different jurisdictions. The weight is 90% and more in Iran, Kuwait, Bahrain and Bangladesh, while it is only 54% in Indonesia and 42% in Malaysia. These obvious differences between jurisdictions make general statements on the basis of aggregate figures and averages for "the" Islamic finance industry or system very problematic.

- A closer look produces further significant differences between countries – for example, between Malaysia and Indonesia. While the relative weight of *sukūk* in the Islamic finance industry is virtually the same in both countries, the fund industry and the OIFIs are well developed in Malaysia but rather small in Indonesia (and virtually non-existent in Bahrain, Turkey and Bangladesh).

- One possible type of cross-sectoral link is through financial conglomerates – that is, groups under common ownership with activities in more than one sector. Such conglomerates undoubtedly exist and are possible channels for contagion, but it has not been possible to consider them in detail in this analysis.

4.1.3 Cross-sectoral Links in Bank-dominated Systems

4.1.3.1 The Aggregate Perspective

To get a better feeling for quantitative peculiarities of Islamic finance – and thus also for the caveats regarding risk in applying insights from conventional finance to Islamic finance – a comparison between the structure of the Islamic finance industry and the structure of conventional finance of a country or group of countries with a dominant banking sector may be useful. The ECB had compiled the shares of bank credit, bond issuance and stock-market (equity) finance for 2005–2009 for the Euro area, the US and Japan (see Table 4.1.3.1.1).

The banking sector is rather small in the capital market-driven system of the US. The banking sector is dominant in the Euro area. The credit share in Japan comes close to Euro area, but the equity share – that is, the importance of stock markets – is much higher in Japan than in most jurisdictions where Islamic finance is practised. Hence, the Euro area may be the best choice for a comparison between Islamic finance and a conventional system in a jurisdiction that has experienced a number of financial crises in the past and for which detailed data are available.

Table 4.1.3.1.1 Share of Credit, Equity and Bond Financing in Conventional Financial Systems

	Euro area	USA	Japan
Credit	51%	18%	44%
Equity	24%	38%	37%
Bonds	25%	44%	19%

Source: ECB 2011, p. 13.

A comparison between the structures of the Islamic finance sector and the conventional finance sector in the Euro area draws attention to the dimensions of subsectors or quantitative proportions that contributed to the spread of sectoral crises through the whole financial system. Chart 4.1.3.1.1 summarises the main quantitative proportions of the financial industry in the Euro area.

Chart 4.1.3.1.1
Financial Institutions and Debt Securities in the Euro Area, 2014
(Total Assets of Sub-sectors in EUR trillion and Shares in %)

Total assets of Euro area financial institutions: EUR 66tn | 100%		
MFIs (monetary financial institutions)	Credit institutions (EUR 28th I 43%)	MMFs (1 I 1%)
		Eurosystem [central banks] (4 I 6%)
ICPFs	Insurance corporations (EUR 7tn I 10%)	Pension funds (2 I 3%)
OFIs (other financial institutions)	Investment funds other than MMF (EUR 10tn I 14%)	
	Remaining financial institutions (EUR 13tn I 19%)	FVCz (2 I 3%)

	EUR tn*
• Loans by MFIs to Euro area residents:	16.9
• Deposits with MFIs on non-MFI Euro area residents:	11.4
• Debt securities issued by Euro area residents, outstanding, total:	16.4
• Debt securities issued by Euro area financial institutions, outstanding:	7.9
• Holding of debt securities by Euro area MFIs:	4.6

Notes: MMFs = money market funds, ICPFs = insurance corporations and pension funds. FVCs = financial vehicle corporations.
Investment funds other than MMFs = equity, bond, mixed, real estate, hedge, and other funds.
**Figures excluding Eurosystem.*
Source: ECB 2015a (p. 103), 2015b, 2016 (pp. S10, S35).

The following differences are significant:

- The weight of commercial banking ("credit institutions") is high in conventional finance, but much higher in Islamic finance (43% vs 72%).
- The weight of the insurance sector is much larger in conventional finance (10%) than is the *takāful* sector in Islamic finance (2%).
- Investment funds other than money market funds are more prominent in conventional finance (14%) than in Islamic finance (approximately 6%).
- The proportion of loans to total assets of conventional credit institutions (60%) is similar to the proportion of debt and equity-like financings to total banking assets (65%) in Islamic finance.
- Conventional credit institutions and money market funds hold 15% of their total assets in the form of debt securities.[225] Detailed statistics of *sukūk* holdings by Islamic banks are not available, but the volume of outstanding *sukūk* allows Islamic banks to hold a similar percentage of Sharīʼah-compliant debt securities on their balance sheets.[226]

In the Euro area, conventional banks hold approximately EUR3 trillion in debt securities (= 10% of their total assets) issued by financial institutions (EUR1.75 trillion by banks, EUR1.25 trillion by other financial intermediaries).[227] In addition, banks have granted loans of approximately EUR1 trillion to other financial inter¬mediaries and hold investment fund shares of approximately EUR0.27 trillion, bringing the total exposure of banks to institutions of the financial sector to approximately 15%. This indicates significantly higher interdependencies within the conventional financial industry compared to Islamic finance. The share of outstanding *sukūk* issued by the financial services industry is 22%, or USD65 billion.[228] If all these *sukūk* were held by Islamic commercial banks (either directly or via shares in Islamic funds), this amount would be equivalent to 5% of the total assets of Islamic commercial banks. There may be some financing by Islamic commercial banks for non-depository intermediaries, but this segment of the Islamic finance industry is far less developed than its conventional counterpart and is therefore neglected here.

The conclusion from these comparisons of sectoral proportions is that, although Islamic finance is even more dominated by banking than the bank-driven financial system of the Euro area, cross-sectoral links between banks and debt securities markets may exist which are not less important in quantitative terms than in conventional finance where these links have the potential to transmit shocks and contagious impulses from the capital markets to banking.

In qualitative terms, however, one important difference should be noted. While nearly half of the outstanding conventional debt securities (48%) were issued by financial institutions,[229] this share is only 22% in Islamic finance. Some 37% were issued by governmental institutions and the remaining 41% by other sectors.[230]

The difference between the issuer structure of conventional and Islamic debt securities implies that conventional and Islamic banks that hold the same percentage have qualitatively different risk exposures. Conventional banks are more exposed to shocks and transmission channels within the financial sector, while Islamic banks are more exposed to risks in the real economy. The high exposure of conventional banks to risks of the financial sector is also documented by the fact that approximately one-third of bank loans are given to banks.[231] A comparable figure for Islamic banks is not published.

Table 4.1.3.1.2 shows the ratios of liquid assets and financing assets (= assets generated from financings including receivable) to total assets (liquidity and financing ratio) of Islamic banks.[232] It does not explicitly show the ratio of "other" assets such as fixed tangible and intangible assets, which is 8% globally.

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225 Calculated from aggregate balance sheet figures for MFIs in the Euro area 2014; see ECB 2016, p. S10.
226 The total volume of outstanding *sukūk* (USD295 billion) even amounts to 23% of Islamic commercial banks' total assets, but not all *sukūk* are held by them. If it is plausibly assumed that *takāful* operators hold 75%, Islamic investment funds 50%, and other Islamic intermediaries 10% of their respective total assets in *sukūk*, and that non-Islamic investors have absorbed 5% of all *sukūk* outstanding, then the total volume of *sukūk* available for Islamic commercial banks would be 295 – 80 = USD215 billion, or 17% of the total assets of Islamic commercial banks. (The absolute amounts of the total assets of these financial institutions can be calculated from Table 4.1.2.1. Given that *sukūk* are primarily structured for institutional investors, individuals and non-financial corporates will most probably invest in *sukūk* only through funds. Hence, a separate estimate of the size of their holdings is not necessary.)
227 For the figures for conventional banks in this paragraph, see ECB 2015b, p. 11.
228 See ICD Thomson Reuters 2015, p. 83.
229 The volume of debt securities issued by Euro-area residents in 2014 amounted to EUR16.4 trillion. Some 48% were issued by financial institutions, 6% by non-financial corporations and 45% by governments; see ECB 2016, p. S35.
230 ICD Thomson Reuters 2015, p. 83. A seeming discrepancy between Chart 1.3.1.2 that shows a share of 80% outstanding *sukūk* issued by "sovereigns" and the 37% "governmental institutions" here is due to different definitions of "public sectors": "sovereign" is much wider and comprises not only governmental institutions but all government-related entities plus multilateral development banks and international organisations which here are reported under "financial services" and the other sectors. Development banks and other financial institutions with public mandates are widely insulated from immediate commercial risks. If they are taken out of the financial services sector, its share in outstanding *sukūk* would decrease.
231 The total volume of loans in the aggregated balance sheet of Euro area MFIs (excluding the Eurosystem) amounts to EUR16.9 trillion of which EUR5.1 trillion (= 30.4%) are loans to MFIs; see ECB 2016, p. S10. Loans to ICPF and OFIs are not shown separately.
232 It should be noted that the term "liquidity ratio" has a different meaning here than in section 3.2, where it was a measure for a bank's ability to pay off its short-term liabilities with its current assets.

Table 4.1.3.1.2
Asset Structure of Islamic Banks

	Global	Malaysia	Saudi Arabia	Iran	UAE	Kuwait	Qatar	Bahrain	Turkey	Indonesia	Bangladesh
All Islamic banks											
- liquidity ratio	16%	22%	22%	16%	17%	24%	16%	12%	21%	15%	24%
- financing ratio	65%	52%	63%	55%	66%	63%	50%	33%	69%	74%	61%
- investment ratio	11%	24%		6%			29%	44%			
Commercial banks											
- liquidity ratio		16%	21%	17%	17%	24%	14%	12%	21%	16%	24%
- financing ratio		59%	64%	57%	66%	63%	63%	60%	69%	74%	60%
Investment banks											
- investment ratio		37%		52%			47%	55%			

Source: Data excerpted from ICD Thomson Reuters 2015.

Some 11% of USD1346 billion gives a volume of USD148 billion that has been, and has to be, invested by Islamic banks. The volume of liquid assets amounts to USD215 billion. It is reportedly "made up of mainly cash and equivalents along with placements for all banks".[233] This should include highly liquid *sukūk* – in particular, those that have been issued specifically by central banks and the IILM for the liquidity management purposes of Islamic banks. This means that a certain volume of *sukūk* can be found in the "liquidity" category. The amount of outstanding *sukūk* available for investment would be reduced by the holding of *sukūk* for liquidity purposes.

As liquidity *sukūk* are short term with tenors of 12 months or less, the total amount outstanding at the end of a year is significantly less than the volume of issuances during that year. Calculated over a long period (January 2001 to July 2014), the share of short-term *sukūk* in total issuances was found to be 43% with a tendency to increase (IIFM 2014, p. 31). With a global issuance volume of nearly USD120 billion in 2014 (see Chart 1.3.1.2), a share of, say, 50% and an assumed average maturity of six months, the amount of short-term liquidity *sukūk* outstanding would be USD30 billion.[234] Islamic banks could use a volume of 295 – 30 = USD265 billion outstanding medium- to long-term *sukūk* for investments.[235]

This amount is far more than the volume for which Islamic banks have to find profitable employments, but banks are not the only investors in this asset class. Other sizeable market players are *takāful* undertakings (with assets of USD33 billion), specialised and wholesale banks (USD36 billion), investment funds (*sukūk* and mixed assets, USD4.5 + 3 billion AuM), investment firms and funds (USD53 billion).[236] These financial institutions with total assets of USD148 billion most probably hold notable volumes of *sukūk*, but detailed statistics are not available. This is also true for another category of market players with a huge absorption potential but a not well-documented *sukūk* appetite: conventional financial institutions (in particular, banks, but also pension funds and sovereign wealth funds both in Muslim and non-Muslim countries). For them, *sukūk* can be vehicles for portfolio diversification with respect to geography, obligor, currency and asset class. Assume, just for the sake of an illustration of dimensions, that *takāful* undertakings hold 66% of their assets in *sukūk*, non-commercial Islamic banks 33%, *sukūk* funds 100%, mixed funds 50%, investment firms and funds 50%, and conventional investors 10% of the outstanding *sukūk*; this would then sum up to USD96 billion. The sum total of *sukūk* assigned to liquidity holdings of Islamic banks and investment holdings of investors other than Islamic banks leaves a volume of USD169 billion available for investments of Islamic banks. Their demand was estimated at USD148 billion, so that all investments could be channelled into *sukūk* (if Islamic banks so decide) and a volume of USD21 billion is left unallocated.

Some lessons can be drawn. First, if the assumptions made for illustration purposes were not too unreasonable, then the estimates of *sukūk* holdings which underlie the available statistics have a significant margin of error. Second, the figures are in line with the hypothesis that Islamic commercial banks prefer, on average, investments in Sharī'ah-compliant fixed-income

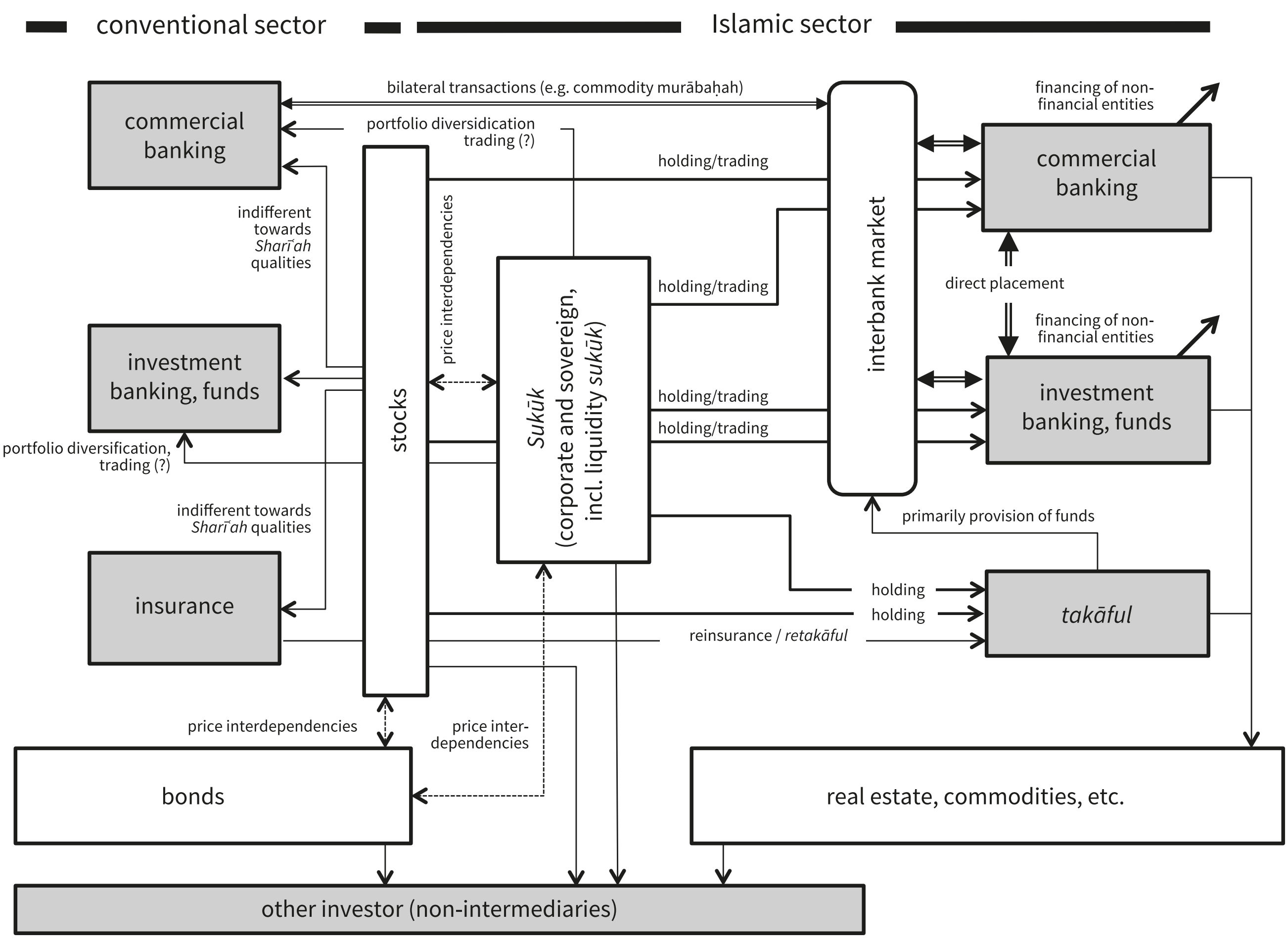
232 It should be noted that the term "liquidity ratio" has a different meaning here than in section 3.2, where it was a measure for a bank's ability to pay off its short-term liabilities with its current assets.
233 ICD Thomson Reuters 2015, p. 47.
234 Neither the 50% share nor the average six months' maturity is backed by statistics. However, they are sufficiently plausible to illustrate quantitative dimensions.
235 The volume can be even higher if the liquid assets of Islamic banks are primarily composed of cash and cash equivalents so that a good part of the short-term *sukūk* are actually used not for liquidity management but for investment purposes by banks or outside the banking sector.
236 For the data, see ICD Thomson Reuters 2015, pp. 70, 94.

debt instruments (*sukūk*) and invest only a small proportion in Sharī'ah-compliant listed shares. Third, it can be easily seen from Tables 4.1.2.1 and 4.1.3.1.1 that an analysis on a highly aggregate level (based on global averages) covers up marked differences in the structure of and processes within the financial industry of different countries.

4.1.3.2 The Disaggregate Perspective

It is clear that the intra- and cross-sectoral links within Islamic finance and between the Islamic and conventional financial systems should be analysed in more detail to identify major stability threads. The general intra- and inter-systemic interconnectedness is outlined in Chart 4.1.3.2.1.

Chart 4.1.3.2.1
Interconnectedness of Actors via Instruments in the Islamic Finance System



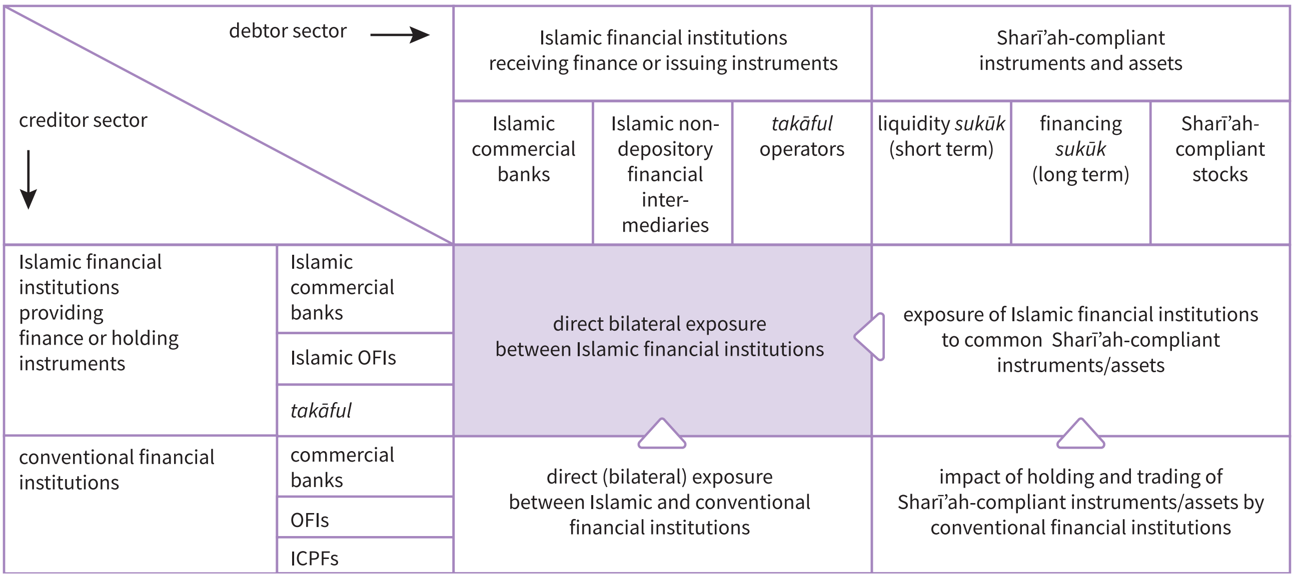
It was not until very recently that central banks in advanced countries have been empowered to attach sufficiently reliable and regularly updated figures to most of the arrows in the chart. This is due to more detailed statistical reporting requirements – in particular, on the holding of securities. For example, the ECB started to publish securities statistics in a "from-whom-to-whom" framework only in 2015 (ECB 2015b, pp. 6–17). "A "from-whom-to-whom" framework allows a detailed presentation of financing and financial investment via securities (debt and equity securities), which has a number of benefits. From a broader perspective, it allows the analysis not only of relationships between institutional sectors and subsectors within an economy, but also of relationships between these sectors/subsectors and non-residents (which can, in turn, be broken down by country or sector). Such an analysis sheds light on the sectoral composition of assets and liabilities, potential strengths and vulnerabilities in portfolios, interconnectedness, and potential spill-overs".[237] Chart 4.1.3.2.2 gives an idea how

[237] "For each type of debt or equity security (whether in terms of positions or flows), a 'from-whom-to-whom' framework has two dimensions:
- Residence, sector, or subsector of the issuer,
- Residence, sector, or subsector of the holder.

… A 'from-whom-to-whom' framework requires three-dimensional tables providing breakdowns for the security, the issuer, and the holder. Such tables show positions, transactions, revaluations and other changes in the volume of assets and liabilities, broken down by the sector of the issuer and of the holder, respectively." BIS, ECB, IMF 2015, p. 69.

a "from-whom-to-whom" table could be structured for Islamic finance in those countries where a significant Islamic capital market has evolved. As long as such an instrument does not exist, only aggregate data and some fractional evidence can be used to analyse intra- and cross-sectoral links.

Chart 4.1.3.2.2
Cross-sectoral Links in Islamic Finance



Interconnectedness through Capital Markets

The aim of the analysis of interconnections within the financial system of a country or a group of countries is an assessment of vulnerabilities and systemic risks resulting from the (over)exposure of financial institutions to particular instruments or types of financial institutions.

In conventional finance, the volume of debt securities issued by financial institutions and held by commercial banks amounts to nearly USD3 trillion, which equals 10% of the banks' total assets. In Islamic finance, 22% of the outstanding *sukūk* (USD65 billion) were issued by institutions of the financial services industry. If all these *sukūk* were held by Islamic commercial banks, their maximum exposure to financial-sector debt securities would be less than 5%.

So, even if the share of debt securities in total banking assets were the same for conventional and Islamic banks, the structure of the issuers seems to be quite different. The vulnerability of Islamic banks to spillovers from capital market crises seems to be less probable than in conventional finance. A few other peculiarities support this view: Islamic finance does not have a well-developed and sizeable derivatives market, and it has so far widely shunned instruments such as credit default swaps that were channels for contagion in the global financial crisis. Furthermore, a shadow banking system with excessively leveraged intermediaries but no access to LOLR facilities (and no potentially unrestricted PSIAs with shock-absorbing qualities in the first round of a crisis) does not, in general, exist in Islamic finance (apart from a few individual institutions).

A conclusion from these observations is that lessons for systemic stability can be drawn, in particular, from a study of banking crises that did not spring, in the first round, from problems in the capital markets and the shadow banking system, but more from a "classic" banking crisis where contagion was primarily within the banking system.

Stock Markets

The holding of conventional shares that are deemed Sharī'ah-compliant by Islamic financial institutions implies a partial overlap of the two systems. Developments in this segment of the conventional market are automatically also developments in a segment of Islamic finance. In principle, all intersectoral and international transmission and contagion channels for financial shocks in conventional finance can also be of relevance for the processing of impulses within Islamic finance. This, however, does not mean that the same mechanics will always produce the same results. The so-called price contagion may serve as an example. In conventional finance, price contagion creates domino effects in the banking sector through links between all banks and the securities markets: fire sales by some large banks of financial assets such as shares will push share prices downwards and cause a decline in the market value of assets (shares) of other banks. Mark-to-market accounting forces these other banks to devalue the asset in their balance sheets with further implications for the capital of the banks, their lending capacity, etc.

This price contagion mechanism is, in principle, as relevant for Islamic banks as it is for conventional banks. However, chain reactions must not always culminate in a banking crisis. They could be moderated, or even prevented, if, for example, the initial shock affected only Islamic banks. A possible scenario is a general increase in the debt financing of non-financial corporates – that is, an increase of leverage in firms of the real economy. This is not a sufficient reason for conventional banks to remove the shares of these companies from their portfolios, but Islamic banks may be forced to do so because the higher leverage exceeds the Sharī'ah compliance threshold. This sets the scene for a fire sale if no, or only too short, grace periods are conceded by the Sharī'ah authorities. However, the process may not lead to a systemic crisis of Islamic banking (as it probably would in conventional banking). For conventional financial institutions, the Sharī'ah compliance of a share is irrelevant. If Islamic banks sell otherwise-attractive shares at some discount, conventional banks should find it lucrative to buy these shares. As conventional banking is much larger than Islamic banking, it is highly probable that conventional banks can absorb the assets which Islamic banks dispose of and thus prevent a crisis triggered by a fire sale. Here, the intersectoral links between Islamic and conventional banks through the stock market have stabilised Islamic finance. [238]

An abstract discussion of a transmission channel does not yet say anything about the quantitative relevance. A look at the balance sheets of a non-representative sample of 24 banks from the GCC and 15 Malaysian banks resulted in the following observations. In the GCC, the share of equities in total assets was 2% or less in 14 banks, in the range of 2–10% in three banks and more than 10% in three banks. It is worth mentioning that all but one of the Islamic banks with the higher shares are located in Bahrain. In Malaysia, six banks reported shares of 2% or less, and one bank a share in the 2–10% range. Eight banks did not provide a figure for their equity holdings. This observation supports the often-articulated view that the exposure of Islamic banks to equity markets is, on average, rather small or insignificant.

Debt Securities Markets

Liquidity is a strong channel for the transmission of contagious impulses between banks (and shadow banks) and the capital market in conventional finance. A lack of liquidity in the securities markets means that a potential seller of a security cannot easily find a counterparty that buys it at a price which fairly reflects the economic value of the security.

Illiquidity in the primary market (i.e. the market for the issuance of new securities) may be due to uncertainties about the solvency of the issuer. Illiquidity in the secondary market may be caused by difficulties in evaluating the substance of a complex security or the expectation of a liquidity crunch that motivates financial institutions to hoard liquidity which they might need themselves in the near future.

In Islamic finance, the primary market for *sukūk* issues was always liquid. Initial public offerings of sovereign and highly rated corporate *sukūk* are usually highly oversubscribed. There is a continuous demand for Sharī'ah-compliant debt-based securities. In particular, Islamic banks and *takāful* operators are looking for risk-minimised investment opportunities. Banks make good use of short- to medium-term *sukūk*, and regulatory reforms will push the demand further as banks need to hold high-quality liquid assets under the new Basel liquidity regime. Short-term sovereign *sukūk* are the most attractive options for Islamic banks. Operators of family *takāful* schemes with long-term savings plans are most interested in *sukūk* with long tenors (which are still in short supply). In addition to the demand by Islamic financial institutions, the primary *sukūk* market has often seen a sizeable demand by conventional financial institutions looking for a diversification of their assets in terms of geography, issuer and currency.

In contrast to the primary market, the secondary *sukūk* market is often described as illiquid. Low turnover rates seem to confirm this. However, there is an important difference between the lack of liquidity in the bond and *sukūk* markets. While a lack of liquidity in conventional markets occurs primarily in periods of crisis and because of reluctant buyers, the lack of transactions in the secondary *sukūk* market is a permanent issue due to the reluctance of sellers. Islamic financial institutions rarely exploit opportunities for a profitable sale of *sukūk* they hold, because they cannot be sure that they will be able to replace it later by another Sharī'ah-compliant security. High-quality *sukūk* are still a rare species, and buy-and-hold is the predominant attitude of Islamic financial institutions. This is quite different for conventional financial institutions that hold *sukūk* in their portfolio. They can easily replace *sukūk* by Sharī'ah non-compliant securities and trade *sukūk* whenever they see a profitable deal.

Although the links between, for example, banks and debt securities markets are structurally the same in conventional and Islamic finance, the speed and intensity of the transmission of impulses from the debt securities market to banking seem to be less stringent in Islamic finance than in conventional finance. Furthermore,

[238] The stabilising effects may also be relevant for Islamic equity funds and *takāful* undertakings with a sizeable exposure to listed shares.

developments in the conventional finance industry that affect the bond market can induce a restructuring of portfolios of conventional banks that hold *sukūk*. The volume of *sukūk* held by non-Islamic institutions is not well documented, but it cannot be ruled out that it is at times, and in particular markets, so sizeable that the trading activities of conventional market players have a stronger impact on the *sukūk* market than the very limited trades of Islamic banks. The calculations at the end of section 4.1.3.1 would allow, under plausible assumptions, a *sukūk* holding by investors other than Islamic finance institutions of 10% or even more of total *sukūk* outstanding.[239] Hence, it is conceivable that the inter-systemic links between the conventional banking and Islamic debt securities markets are as powerful and responsive as the intersectoral links in Islamic finance.

Interconnectedness across Countries

Financial institutions are exposed not only to other financial institutions (and the real economy) in their own country but also to counterparties in different jurisdictions. The exposure to foreign counterparties is particularly high for offshore banks and financial institutions in locations that aim to become international hubs for particular financial services offered to foreign customers. A high exposure to foreign counterparties can bring additional layers of risk, such as foreign exchange risks or risks from foreign legal systems and political decisions. Intense interconnections with foreign economies can boost the financial sector of a country to unstainable dimensions (e.g. as was the case with Ireland, Iceland and Cyprus).

Roughly one-quarter of the *sukūk* volume outstanding is classified as international, meaning that the *sukūk* have been issued not in the local currency but an international one, primarily US Dollars. These *sukūk* are targeting Islamic investors abroad as well as conventional global market players. While information on the primary market buyers is available, secondary market transactions are predominantly OTC and not registered in commonly used *sukūk* databases. Hence the knowledge of the geographic holder structure of traded *sukūk* and cross-country links is quite fragmentary for most jurisdictions, but it seems that the links are more within the Asian and Arab regions than across regions.

Interconnectedness through Unique Common Features

The stability of a financial system is threatened by unexpected "events" or "shocks" – for example, the simultaneous materialisation of usually uncorrelated and individually manageable risks, or the gradual build-up of a situation where individually harmless ingredients create a previously unknown "explosive" mixture.

As far as financial parameters are concerned, economists, regulators and legislators have recognised that they had not learned enough from many past crises to prevent the GFC of 2007–2009. If Islamic finance were only finance, it would be reasonable to assume that the building blocks of the systems and their interactions would be structurally similar to conventional finance, and knowledge about shock transmissions and crises prevention could be transferred – with some adjustments and calibrations – from the conventional to the Islamic system. This may be true, but it would not be the whole picture, as the sectors of Islamic finance are also linked through their Islamic dimension. This linkage could spread shocks of a specific type that is unknown in conventional finance through the whole Islamic financial system. This adds a new layer to crisis scenarios.

Sharī'ah Non-compliance Risk

Industry players and regulators have identified a Sharī'ah non-compliance risk. This risk is defined by the IFSB-1 as "the risk that arises from IIFSs' failure to comply with the Sharī'ah rules and principles determined by the Sharī'ah Board of the IIFS or the relevant body in the jurisdiction in which the IIFS operate".

This risk is a threat to the profitability of IFIs, and it may damage the reputation not only of an individual firm but of the whole industry. Sharī'ah non-compliance of an individual Islamic financial institution could be contagious, especially when there is a lack of transparency in rather complicated structures. However, it has hardly enough destructive potential to threaten the stability of the Islamic finance system as a whole. In the terminology of economists, the Sharī'ah non-compliance risk is not a "shock" but a risk that is, in principle, not unexpected or exogenous, and Islamic financial institutions (IFIs) may be forced by regulators to build reserves to absorb financial losses resulting from an eventual materialisation of this special form of operational risk.[240]

Sharī'ah-related Shocks

A systemic threat comes from Sharī'ah-related shocks which are unexpected events with a significant destructive potential. The following are some examples of possible (not totally fictitious) Sharī'ah-related shocks that are different from the Sharī'ah non-compliance risk as defined by the IFSB:[241]

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[239] *Sukūk* are rather complex securities structured for institutional investors, and retail *sukūk* are a very recent and – in quantitative terms – still marginal addition. Although it cannot be ruled out that Muslim individuals and non-financial corporations hold some *sukūk*, the largest part of the investors other than Islamic finance institutions are conventional domestic or international financial institutions.

[240] IFSB. (2016). Capital Adequacy Requirement on Operational Risk: Sharī'ah non-Compliance Risk for the Banking Sector.

[241] The IFSB definition assumes a breach of an existing Sharī'ah rule in a specific contract or a Sharī'ah non-compliant behaviour of a particular Islamic finance institution. The shock scenario assumes that either rules or practices which were approved by Sharī'ah scholars and widely practised in the industry turn out to violate Sharī'ah principles or are overruled by, for example, a well-known Sharī'ah scholar or a court or a government decision.

- A court of a country decides that a widely used product that was approved by the Sharī'ah boards of Islamic banks and the Sharī'ah board of the central bank violates Islamic principles (as they were understood by the judge) and has to be abandoned.
- The highest Sharī'ah court of a country analyses the practice of the Islamic banks and declares them to be "un-Islamic". Furthermore, the court rules that laws and regulations underlying the banking practices shall become void after six months.
- An internationally recognised group of Sharī'ah scholars has issued a directive for the Sharī'ah-compliant structuring of a capital market product. After a couple of years, a leading scholar, who was member of that group, notices that the Sharī'ah boards of many issuers have approved structuring practices that deviate so substantially from the directive that he considers them no longer Sharī'ah compliant. No Sharī'ah board of a central bank or securities commission had opposed these practices before. The scholar approaches the media and alarms the public.
- A government decides that the practice of smoothing profit payouts for PSIAs that had been approved by the Sharī'ah boards of banks and by the national Sharī'ah board has to be terminated and PSIA holders have to be warned that they hold an investment product, meaning that their capital is exposed to the risk of loss.

All these examples of Sharī'ah-related shocks require far-reaching modifications of practices and business models of Islamic banks. They can damage the reputation of Islamic finance, shake the confidence of customers, and cause sizeable costs or losses for IFIs as a consequence of fire sales of assets, termination and unravelling of contracts, claims for damages, reorganisation of business processes, etc.

In an atmosphere of goodwill and mutual support of banks, customers and authorities, a relatively smooth absorption of such Sharī'ah-related shocks is conceivable. The government may clarify how to settle Sharī'ah-related disputes; the legislator extends the traditional period and gives guidance for a fresh start of the system; the issuers change *sukūk* structures of new issuances but do not unwind existing securities; and the government supports the financial industry in the development of alternative products. Under such favourable conditions, and with the support of committed authorities, a systemic crisis can be averted.

But in an economic downturn and a climate of confrontation and conflict, the shocks might scale up and trigger a crisis of the whole Islamic financial industry.

The transmission and contagion channels within the Islamic finance industry, and between Islamic finance and the real economy, are not fundamentally different from what can be found in conventional finance,[242] but the triggering event is of a particular nature. The crisis scenario may include a run on Islamic commercial banks, but also a collapse of the market for Sharī'ah-compliant debt securities. In contrast to mitigating effects in case of a loss of Sharī'ah compliance in the stock market discussed previously, compensating forces from the reaction of conventional market players may not become effective here. While fire sales of stocks by Islamic banks do not change the fundamental qualities of the stocks for conventional market players, fire sales in the *sukūk* market may be taken by conventional market players as an indication for doubts about the legal qualities of these securities (such as the validity and enforceability of the underlying contracts). The signal for conventional market players then reads "sell" and not "buy", as it was in the stock market case, and this would not mitigate – but, instead, fuel – the crisis.

A common denominator of the outlined Sharī'ah-related shocks is limited knowledge about possible weak spots in Islamic finance and a lack of transparency and clarity. Practices that violate agreed-upon principles can spread only in an opaque business environment and a general climate of carelessness. Irritating court rulings may spring from a lack of expertise of judges. Policy changes are perceived as abrupt and sudden when public debates are shunned. Although prudential regulation alone cannot address all these issues, it can make a notable contribution. Reduced opaqueness, improved transparency, better disclosure, more clarity, consensual standards, education and advice – all this would help to reduce the realm of the unknown and – maybe – transform the character of Sharī'ah-related shocks from uncontrollable uncertainty into manageable risk.

4.2 ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM REGULATIONS AND THE ISLAMIC FINANCIAL SERVICES INDUSTRY

4.2.1 Progress on the Regulatory Framework for AML/CFT at the Global Level

Today, there is unanimous acceptance of the need to address effectively the risks posed by money laundering and terrorism financing to the socio-economic stability and sustainable growth of global society. Consequently, there is a strong commitment across the board from almost all the countries in the world to ensure robust and effective anti-money laundering (AML) and countering

[242] See the literature reviews in Kolb 2011; BCBS 2011, 2013; Freixas, Laeven and Peydró 2015.

the financing of terrorism (CFT) regimes. The intimate relationship between money laundering or terrorist financing and various types of predicate crimes that pose hazards to the global society in many forms continues to emphasise the importance of AML regimes and their effectiveness in battling crime.

The series of terrorist incidents across the world over the past two decades or so that have not only endangered the lives of countless people and disturbed global peace, but also destroyed enormous wealth and opportunities for economic progress, have only served to underline further the critical importance of having effective AML/CFT regimes in every jurisdiction of the world.

Money laundering is the process by which the illicit source of assets obtained or generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity, thereby abetting the criminal activities in the form of converting their proceeds into legitimate funds. Terrorist financing involves the raising and processing of funds to supply terrorists with resources. While money laundering and terrorist financing differ in many ways, they often exploit the same vulnerabilities in financial systems that allow for an inappropriate level of anonymity and opacity in the execution of financial transactions.

4.2.2 The Structure of the AML/CFT Standards

The global standards for AML/CFT have evolved around the establishment, growth and evolution of the Financial Action Task Force (FATF[243]), which has successfully cemented its place as the organisation leading the efforts in respect of AML/CFT.

The FATF is the global standard setter for AML/CFT standards and is mandated to develop and ensure effective implementation across its member jurisdictions. The status of FATF has been further strengthened by the acceptance of its standards as de-facto regulatory requirements on the international scene by the global multilateral institutions such as the IMF and World Bank.

4.2.3 The FATF Institutional Framework: International and Regional Cooperation

The FATF is an inter-governmental body established in 1989, in response to mounting concern over money laundering. Its membership has grown steadily from 14 countries at its inception, to 34 jurisdictions[244] and two regional organisations at present, representing almost all the major financial markets across the world. The FATF has capped its membership, but is complemented by nine regional task forces, which has expanded its remit to about 180 countries around the world.

The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The FATF believes that enhanced global compliance with established standards reduces the money laundering/financing of terrorism risks to the international financial system, and increases transparency and effective international cooperation. The FATF is therefore, in part, a "policymaking body" that works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.

As the primary component of its efforts to ensure a high level of regulation in relation to AML and CTF, the FATF has developed standards, which are referred to as "FATF Recommendations" and have a similar status to the Core Principles of sectoral standard setters such as the Basel Committee. The FATF Recommendations are recognised as the international standard for combating money laundering and the financing of terrorism. They are intended to be applied universally and form the basis for a coordinated response to these threats to the integrity of the financial system and help ensure that there are no gaps or weak spots in the global AML/CTF framework. The FATF Recommendations were initially published in 1990, and have since been revised in 1996, 2001, 2003 and, most recently, in 2012 to ensure that they continue to be relevant.

The FATF Recommendations, now 40 in number, cover a broad range of issues, including the regulation of services provided by financial institutions and some non-financial businesses and professions, cross-border movements of currency, the transparency of legal entities, substantive and procedural criminal law, institutional capacity, sanctions, as well as domestic and international cooperation. Of these 40 recommendations, about 35 are aimed at addressing issues related to AML and four recommendations exclusively address CFT issues.

The most important changes in the latest version of the FATF Recommendations are:

- the increased prominence of the so-called risk-based approach to AML/CFT;
- the inclusion of tax crimes in the list of designated predicate offences to money laundering;
- the greater emphasis on action against corruption; and
- the limited extension of the standard to the proliferation of financing-related issues issues.

Following the release of the latest version of its Recommendations, the FATF has developed a new assessment methodology that goes beyond technical

[243] Sometimes known by its French acronym, GAFI.
[244] Currently, two OIC countries are members of FATF, namely Malaysia and Turkey.

compliance in respect of the key elements of the AML/CFT regimes and lays greater emphasis on their effectiveness in achieving their intended objectives.

4.2.4 Compliance Monitoring Mechanism: The FATF Mutual Evaluation Process

In addition to the FATF's standard-setting role, the Task Force and the FATF-Style Regional Bodies FSRBs are also mandated to conduct "mutual evaluations" (or peer reviews) of their members, publish the results of these reviews, and follow-up on the progress made by the assessed countries in addressing the main deficiencies identified in the course of the evaluation. As part of its efforts to fulfil its mandate, the FATF conducts such mutual evaluations of each of its members on an ongoing basis to assess levels of implementation of the FATF Recommendations. The reports published by the FATF following such mutual evaluations provide an in-depth description and analysis of the subject country's framework for preventing abuse of the financial system in relation to money laundering and financing terrorism, as well as other criminal activities. Consequently, the FATF also monitors the progress of its members in implementing measures necessary to ensure effective implementation of its recommendations.

The majority of the members of the FATF and its regional bodies have already committed to implementing the FATF standard as well as undergoing regular mutual evaluations. As part of its monitoring efforts, the FATF reviews money laundering and terrorist financing techniques and counter-measures, and promotes the adoption and implementation of appropriate measures globally. In collaboration with other international stakeholders, the FATF works to identify national-level vulnerabilities with the aim of protecting the international financial system from misuse.

In addition to mutual evaluations organised by the FATF and its regional bodies, the International Monetary Fund has made material contributions to the efforts of the international community to combat money laundering and terrorist financing. The key contributions made by the IMF have been towards execution of assessments of countries' compliance with the FATF Recommendations and capacity development activities. These compliance assessments carried out by IMF teams have formed part of both the Reports on the Observance of Standards and Codes (ROSC) programme and the Financial Sector Assessment Programme.

In addition to the mutual evaluation and follow-up processes carried out by the FATF and FATF-style regional bodies, the Task Force uses additional mechanisms to identify jurisdictions with strategic deficiencies in their AML/CFT regimes that pose a risk to the international financial system. The FATF also calls for action to address such deficiencies and monitors actions taken by relevant authorities to improve compliance.

Between 2000 and 2006, the FATF conducted the process on non-cooperative countries and territories (NCCTs), which identified 23 jurisdictions as suffering from lack of an effective AML/CFT system. The process was highly successful as all of those 23 jurisdictions made significant progress, and the last country was removed from the list in October 2005.

Since 2007, the FATF's International Co-operation Review Group (ICRG) has taken over the NCCT process and analysed high-risk jurisdictions and recommended specific actions to address the ML/FT risks emanating from them. Following the recommendation from G-20 in 2009 to strengthen its mutual evaluations process and to publicly identify high-risk jurisdictions by February 2010, the FATF adopted enhanced ICRG procedures in June 2009. Since then, the FATF has regularly updated the public list of jurisdictions with strategic deficiencies, based on the review of the efforts made by the relevant jurisdictions by the ICRG. On the basis of the review by the ICRG, the FATF publishes the list of jurisdictions with strategic AML/CFT deficiencies in its public documents – the FATF Public Statement (call for action) and Improving Global AML/CFT Compliance: On-going Process (other monitored jurisdictions), which are issued three times a year.

Given the critical role of the FATF and the mandate it receives from the G-20, the NCCT process, and the list of jurisdictions identified by it as having strategic deficiencies, assumes enormous importance in respect of the attractiveness and acceptability of a country or a jurisdiction to potential trading or investment partners and ongoing relationships with their financial services systems. Apart from the explicit prohibitions or restrictions on various services offered in such identified jurisdictions by a variety of financial market participants, including IIFS, the identified jurisdictions are also affected by the adverse reputational impact of such publications. In practice, calls from the FATF to its members to apply strong counter-measures to protect their financial systems results in market participants implementing restrictions or explicit bans on various key services provided to financial institutions from the countries affected by the NCCT process. Identification by the FATF as a country with strategic deficiencies in respect of AML/CFT standards limits the potential for investment and trade with the rest of the world and the scope of ongoing business relationships for its constituents, not necessarily limited to the financial services sector.

A review of the latest public statement issued by the FATF in October 2015 indicates that a very high proportion of IFSB member jurisdictions have achieved acceptable levels of compliance with FATF standards. This is reflected by the fact that only one member of the IFSB is mentioned in the list of high-risk and non-cooperative jurisdictions by the FATF, and only one observer member is currently in the list of jurisdictions subject to ongoing improvement process. One of the full members of the IFSB has been noted by the FATF for making significant progress in improving its AML/CFT regime and will no longer be subject to the Task Force's monitoring process.

4.2.5 AML/CFT Regime Applicable to Institutions offering Islamic Financial Services

The regulatory regime for IIFS, covering various aspects of regulation from licensing to enforcement, has many elements in common with the conventional financial institutions (FIs) in most jurisdictions. With respect to the AML/CFT framework, most jurisdictions have chosen to apply the conventional framework on IIFS, particularly in respect of the primary legislation and rules and regulations. In a few countries, however, the authorities have opted for providing specific guidance to assist the IIFS in implementing an effective AML/CTF regime and to comply with the relevant legal and regulatory requirements.

In all the jurisdictions assessed by the FATF as not being subject to an ongoing improvement process, the IIFS are subject to national laws and regulations relating to AML/CTF and are expected to comply with the requirements, including reporting requirements to the national Financial Intelligence Units (FIUs), as in the case of conventional FIs.

Because of the common regulatory regime applicable to their businesses, the compliance and risk management systems, controls and processes employed by IIFS to address AML/CFT risks and to ensure compliance with applicable AML/CFT laws and rules are not very dissimilar to those employed by conventional FIs.

In consideration of the fact that the money-laundering and terrorism financing risks faced by IIFS are not materially different from those faced by conventional FIs, and that similar legal and regulatory regimes are applicable to IIFS and conventional banks in almost all the jurisdictions, the standard-setting bodies in the Islamic financial services industry have not found adequate reason to prioritise standard-setting work in the AML/CFT domain. The IMF, in the past, has stated that there is not much evidence to support the position that ML/FT risks in the Islamic finance segment are significantly elevated in comparison to those posed by the conventional finance sector. Similarly, the choice of whether to launder the proceeds of crimes or to finance terrorism through conventional or Islamic finance institutions would appear to be dictated by convenience and opportunity, rather than by inherent differences between themm.[245] As stated in a recent IMF Working Paper, "Islamic financial institutions should build additional experience in assessing the ML/TF risks they are facing, and in effectively implementing preventive measures tailored to the characteristics of their products and services." The paper also highlights that "the specific nature of the relationship between a financial institution and its customers, the modus operandi of Islamic financial institutions and the complexity of certain transactions" merit further attention.[246]

However, the IMF has underlined the value of a joint study involving the FATF, standard setters in Islamic finance and national regulators aiming to achieve a deeper understanding and appreciation of the ML/FT risks relevant to Islamic finance, including the extent to which current AML/CFT obligations require further adaptation. This section is an attempt to delve into some aspects of the operations of IIFS that could impact the ML/FT regulatory regimes in various jurisdictions. The IFSB has included in its Strategic Performance Plan 2016–2018 plans to conduct detailed research on this subject, which will possibly involve a survey of the IFSB member jurisdictions.

Box Article 4.2.1: AML/CFT Regulations in Malaysia

Malaysia is an example of a jurisdiction where, despite operating dual systems with both conventional financial institutions and IIFS, national AML/CFT Regulations are effectively applied on its overall financial sector. The Law and Policies of the country recognise the presence and businesses undertaken by IIFS and necessary corrective and punitive measures are aptly applied where violations are identified.

As the competent authority under the Anti-Money Laundering, Anti-Terrorism Financing and Proceeds of Unlawful Activities Act 2001 (AMLA), the Malaysian Central Bank, Bank Negara Malaysia (BNM) works with other relevant agencies that form the National Coordination Committee to Counter Money Laundering (NCC) to ensure that safeguards are in place and operating effectively to prevent money laundering and terrorism financing in the country. On the regulations parts, the AML/CFT Policies issued by BNM are segregated across 5 sectors,[247] namely:

- Banking and Deposit-Taking Institutions (Sector 1)
- Insurance and *Takāful* (Sector 2)

[245] IMF Staff Discussion Note (2015), *Islamic Finance: Opportunities, Challenges, and Policy Options*.
[246] IMF Working Paper (2016), *Islamic Finance and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)*, February.
[247] BNM: AML/CFT Law and Policy – Available online at http://amlcft.bnm.gov.my/AMLCFT07.html

- Money Services Business (Sector 3)
- Electronic Money and Non-Bank Affiliated Charge & Credit Card (Sector 4)
- Designated Non-Financial Businesses and Professions (DNFBPs) & Other Non-Financial Sectors (Sector 5)

Sector 1 is duly applicable to all banking and deposit-taking institutions including Islamic banking business as defined in Malaysia's Islamic Financial Services Act 2013. Similarly, Sector 2 is applicable to the *Takāful* business under the Islamic Financial Services Act 2013. AML/CFT obligations imposed on reporting institutions are stipulated under Part IV of the AMLA and provided in the AML/CFT Policies listed above.[248] The obligations include the requirement to:

i. implement AML/CFT risk management that commensurate with the level of money laundering and terrorism financing risks;
ii. conduct customer due diligence;
iii. keep proper record on the customer and transactions;
iv. implement AML/CFT compliance programme;
v. report suspicious transaction report (STR); and
vi. report cash threshold report (CTR) for cash transaction exceeding RM50,000 or whichever amount specified.

Efforts to strengthen safeguards against threats of money laundering and terrorism financing (ML/TF) is a key priority for BNM. In 2015, BNM observed a continued emphasis on strengthening AML/CFT controls and practices among banking institutions. This has been evident in increased resources allocated to, and investments in, screening and transaction monitoring systems. BNM has also noted improved practices in the conduct of customer due diligence (CDD). Further enhancements in governance and control measures were identified to improve processes for identifying transactions designed to evade reporting obligations and for assessing risks associated with politically exposed persons.

During the year (2015), BNM also progressed its internal initiatives to better integrate financial intelligence with its prudential supervision of banking institutions. This involves developing a structured process to incorporate, in a consistent way, results from annual AML/CFT assessments and analyses of trends and patterns in BNM's risk-based supervisory framework. Such an integrated approach aims to leverage on BNM's supervisory activities more effectively to support timely interventions by the central bank to pre-emptively address AML/CFT weaknesses identified in banking institutions. As an expected outcome of this work, banking institutions with weak AML/CFT systems will be subjected to closer and more intensive supervision and enforcement action.

Enforcement actions continue to be pursued by BNM to safeguard the integrity of the financial system. In 2015, the central bank successfully prosecuted 182 criminal offences and obtained six court orders requiring entities and/or individuals to cease operating illegal activities.[249] In addition, RM69.5 million in fines were imposed on licensees for regulatory breaches and 26 new investigations were opened during the year into suspected illegal activities and regulatory breaches. Particular to Islamic finance, compounds amounting to RM1.05 million was issued against two Islamic banks for failure to comply with AMLA Orders under section 48 and section 50 of AMLA. Furthermore, administrative monetary penalties amounting to RM57.6 million were applied against three banking institutions for failure to comply with standards prescribed by BNM under section 48(1) of FSA and section 58(1) of IFSA.

Between 2013 and 2015, this work has been subjected to close international scrutiny under the mutual evaluation of Malaysia's AML/CFT framework (ME Report) by the Financial Action Task Force (FATF). In September 2015, the FATF published its report on Malaysia[250] which affirmed the high degree of technical compliance with international standards on combating money laundering and terrorism financing. BNM's coordination with the NCC helps to ensure the effective implementation of these standards across all reporting entities whose activities are exposed to risks of financial abuse.

Drawing in part on the recommendations of the ME Report, the NCC has formulated a five-year National AML/CFT Strategic Plan to promote and protect the integrity of Malaysia's financial system over the long term and contribute towards mitigating criminal activity in the country. Based on the commitment demonstrated by Malaysia's action plan and the continuing progress in efforts to improve its AML/CFT programme, Malaysia was granted full membership of the FATF in February 2016.[251]

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[248] BNM: Reporting Obligations Under The AMLA – Available online at http://amlcft.bnm.gov.my/AMLCFT05.html
[249] BNM: The Financial Stability and Payment Systems Report 2015
[250] Available - http://www.fatf-gafi.org/media/fatf/documents/reports/mer4/Mutual-Evaluation-Report-Malaysia-2015.pdf
[251] BNM: The Financial Stability and Payment Systems Report 2015

However, the IMF has underlined the value of a joint study involving the FATF, standard setters in Islamic finance and national regulators aiming to achieve a deeper understanding and appreciation of the ML/FT risks relevant to Islamic finance, including the extent to which current AML/CFT obligations require further adaptation. This section is an attempt to delve into some aspects of the operations of IIFS that could impact the ML/FT regulatory regimes in various jurisdictions. The IFSB has included in its Strategic Performance Plan 2016–2018 plans to conduct detailed research on this subject, which will possibly involve a survey of the IFSB member jurisdictions.

4.2.6 Funding Side Products of Islamic Banks: Distinguishing Features from Conventional Deposit Products and Risk Mitigants

Islamic banks from across the main Islamic banking markets of the world typically fund themselves with a few primary categories of liability products, though with minor variants of these products. These are:

- profit- or loss-sharing investment accounts
- sale-based contracts – reverse commodity *murābaḥah* transactions (CMT) or *tawarruq*
- non-interest-bearing accounts – similar to current accounts in conventional banks.

These liability products are employed in both the retail and wholesale funding markets by IIFS to raise funding, though the relative shares and importance of these products across retail and wholesale markets vary from IIFS to IIFS depending on their funding strategy.

Irrespective of their structure or the Islamic contracts on which they are based, the funding products employed by Islamic banks essentially serve the same purpose as those employed by conventional banks. The similarities with the funding products of conventional banks extend to the operational processes and procedures employed. Of more relevance to this current discussion, the similarities also extend to the AML/CFT procedures and related compliance obligations. The similarities in terms of ML/TF risks and AML/CFT measures are equally applicable to the operation of these product categories in retail as well as wholesale markets, though the nature of counterparties in wholesale markets results in a relatively lower level of ML/TF risks.

In order to mitigate or preclude the risk of ML/TF in the form of layering or placement of illegitimate profits into their operations, IIFS are expected to apply the same controls and protective measures as conventional banks. A proper AML/CTF compliance regime should be in place with appropriate resources in the form of well-trained people and specialised designated units to ensure effective implementation of their AML/CFT regime. The level of ML/TF risks faced by IIFS in respect of their liability products or fund-raising operations is no higher than that faced by conventional banks operating in the same areas.

Some of the funding products, such as those based on tawarruq or reverse CMTs, involve trading in real assets. Tawarruq is a commodity-based reverse *murābaḥah* that commonly involves three sales contracts and three or more independent parties. It is frequently used to deliver money to a person wishing to avoid borrowing at interest, or as a deposit product.

As a source of funding for an Islamic banking business firm, a CMT involves a customer first buying a highly liquid commodity and selling it to the firm on a deferred payment basis at an agreed price (with a profit margin), and then the firm on-selling the commodity on the spot market to another buyer.

Although the reverse CMT seems to describe the funding provider or investor as a counterparty to the IIFS in the transaction, IIFS using such contracts to raise funding for their business are expected to treat the counterparties on such contracts as customers investing funds. Consequently, in respect of AML/CTF regulations, IIFS are expected to treat them in the same way as conventional FIs treat their depositors or other types of investors. In practice, the IIFS treat funding providers through reverse CMT contracts as customers and subject them to required levels of Know Your Customer (KYC)/customer due diligence (CDD) and evaluation of source of funds and source of wealth.

Reverse CMT involves additional processes and third parties in completing the execution of the transaction or product, which brings the complexity of the product issue and whether this additional layer of complexity leads to more vulnerability into consideration, as discussed by the IMF. Looking at the detailed process adopted for these transactions, it appears that those additional steps or the involvement of third parties do not have any economic or monetary implications for the transaction or for the product being provided by the IIFS to its client. Such additional steps and the involvement of third parties serve a limited purpose of ensuring Sharīʿah compliance and are devoid of any transfer of monetary value to parties other than the IIFS and its client. The third parties or brokers involved in such transactions are commonly registered with their respective commodity trading platform, such as the London Metal Exchange or Bursa Suq Al Sila in Kuala Lumpur. However, in some domestic markets, the brokers involved in facilitating the CMT might not have gone through the same due diligence process as in more established exchanges, which could require strengthening these processes through both risk mitigation and ML/FT regulation.

In specific reference to PSIAs and other non-remunerative deposit accounts, the product characteristics, as well as operational processes and procedures related to such accounts, are no different from those of the funding products employed by conventional FIs. Similarly, the legal requirements in respect of AML/CTF and risk mitigation measures to address money laundering and terrorist financing risks in respect of PSIAs and other non-remunerative deposit accounts are identical to those applicable for deposit accounts offered by conventional FIs, including those offered by conventional investment funds and non-banking finance companies. Therefore, in almost all the jurisdictions with significant market penetration of PSIAs and other non-remunerative deposit accounts, the IIFS are required to comply with the same CDD and KYC obligations as their conventional counterparts.

4.2.7 Role of Islamic Banks in *Zakāh* and Charity Collection – Are There Any Loopholes?

Zakāh refers to the determined share of wealth prescribed by Allah Almighty to be distributed among the deserving categories of those entitled to receive it on an annual basis. *Zakāh* is an instrument of philanthropy which forms a core component of Islam (one of the five pillars), especially aimed at facilitating the social-economic dimensions of Islamic finance in terms of income/wealth distribution, mitigating economic inequalities and poverty alleviation. Apart from the obligation on individuals on payment of *zakāh*, it is now widely established in many countries that businesses are also subject to an obligation to pay *zakāh* out of their earnings, which is applicable to IIFS as well. In addition to the obligation to pay *zakāh*, IIFS also pay charity as a means of purification of their actions and results, some of which may have contravened the provisions of Sharīʹah in the course of their business activities.

4.2.8 *Zakāh* Collection and Distribution by IIFS

Given their role as Sharīʹah-compliant financial institutions, some Islamic banks are involved in both collection of *zakāh* payments on behalf of government agencies and payment of *zakāh* as part of their obligations under Sharīʹah. There are existing instances of Islamic banks playing the role of *zakāh*-collecting bodies, both in traditionally Muslim-dominated countries and in secular countries.[253]

In relation to AML/CFT regulations and their application to the Islamic finance industry, the role of IIFS in the collection of *zakāh* and in passing on such collections to eligible beneficiaries of such *zakāh* collections is far more relevant than the payment of *zakāh* by the IIFS themselves. In respect of their activities relating to *zakāh* collection and distribution, it is essential for an IIFS to ensure that it is dealing with donors and recipients who are well known to them and are compliant with applicable AML/CFT regulations. In the case of both donors and recipients, IIFS collecting or paying funds meant to be *zakāh* would be making payments and collecting receipts, which would amount to typical banking transactions. Such banking transactions would need to be covered under the KYC/CDD rules and regulations that are applicable in every country. Such regulations, when compliant with FATF standards, would require that the parties making the payment to the IIFS or receiving payments by the IIFS are identified as clients of the IFI and are subject to applicable KYC/CDD processes.

In the case of *zakāh* collections for, or *zakāh* distribution payments through, government agencies or other forms of intermediaries, it would be required under relevant AML/CFT rules and regulations that such parties are identified as business partners and subject to Know Your Partner and associated due diligence requirements.

The role of IIFS in transmitting *zakāh* collections to non-profit organisations (NPOs) exposes them to AML/CTF risks owing to their association with NPOs. The payment of *zakāh* on their own behalf, as well as collections from its customers to charities which are mostly NPOs, increases the potential exposure of such transaction to AML/CTF risks arising from potential abuse of such NPOs. These risks have been highlighted by the FATF in a report of typologies titled Risk of Terrorist Abuse in Non-Profit Organizations, published in June 2014.

NPOs with the noble aims of carrying out initiatives to benefit the underprivileged and needy sections of society may be identified as a target for abuse by groups whose goals are not entirely benevolent. The most extreme form of such abuse is posed by groups engaged in terrorist activity. Terrorist organisations and NPOs have diametrically opposite objectives but often seek similar resources and tend to rely on similar logistical capabilities. This exposes NPOs to potential abuse by terrorists or terrorist networks.

FATF Recommendation 8 requires that countries review their laws and regulations to ensure that NPOs cannot be abused for the financing of terrorism. The typologies report from FATF referred to above used case studies as well as inputs from law enforcement, government authorities and NPOs to examine, in detail, the risks of CTF abuse for NPOs. The key findings that emerged from the study were as follows:

- The NPO sector's interconnected vulnerabilities are sought to be exploited by terrorist entities, with diversion of NPO funds being the dominant method of abuse.

[253] For example, Al Rayan Bank in the UK (formerly, Islamic Bank of Britain) has a partnership with the National Zakat Foundation (NZF) in the UK, as part of which it collects *zakāh* payments directed towards NZF. NZF is a registered charity that aims to utilise *zakāh* funds and voluntary donations collected in the UK for the benefit of local, deserving recipients, including refugees, asylum seekers, single mothers, the elderly and the homeless (www.alrayanbank.co.uk/useful-info-tools/about-us/latest-news/jan-dec-2015/al-rayan-bank-announces-charity-partners-for-2015/).

- NPOs most at risk appear to be those engaged in "service" activities, and that operate in close proximity to an active terrorist threat.

The typologies report also observed that complicit organisations relied on deception to mislead donors and other NPOs, and to exploit the NPOs for abuse. The report also identified two types of indicators that could help the NPO sector and financial institutions handling the funds of NPOs to identify potential abuse in NPOs. The "risk indicators" are related to compliance with applicable AML/CFT laws and rules that may or may not be terrorism-related; while a second set of indicators, termed "terrorist abuse indicators", provide alerts to government authorities regulating NPOs or FIs.

FATF Recommendations 24 and 25, pertaining to transparency and beneficial ownership of legal persons and arrangements, require that adequate, accurate and timely information should be maintained on the beneficial ownership of legal persons and legal arrangements which are NPOs and other beneficiaries of donations such as *zakāh* and sadaqa (charity). These FATF standards also require that the KYC/CDD information on NPOs should be available for timely access by competent authorities. These requirements entail a robust KYC/CDD process and other elements of AML/CFT regime to be applied to NPOs as stringently as they would be applied to other segments of customers or business partners of IIFS.

The above heightens the need for a robust AML/CTF regime, and relevant systems and controls, to monitor and mitigate potential risks of transacting with NPOs in the process of *zakāh* collection and transmission.

Given the important role played by NPOs and the contribution of *zakāh* payments in supporting various sections of the society, the controls and mitigation measures employed must not be unduly restrictive and should be very much focused on addressing relevant AML/CTF risks.

The typologies report published by FATF facilitates implementation of a robust risk-based approach by providing a number of red-flag indicators to assist IIFS to identify and investigate potential cases of abuse.

The application of relevant AML/CFT regulations to the role of IIFS in *zakāh* collections and its effective implementation seems to have addressed the AML/CFT risks and, consequently, has mitigated, to a reasonable extent, the risk of breaches in this area. Moreover, the FATF's mutual evaluations and other monitoring processes have not identified any issues with the role of IIFS in *zakāh* collection and distribution, which is further evidence of the coverage of this issue in IIFS.

4.2.9 Financing Side Products of Islamic Banks

Islamic financial contracts typically used for providing financing to customers on the assets side of IIFS can be broadly classified into the following categories, which would help us to analyse them from the perspective of the AML/CTF risks involved.

- sale-based contracts such as *murābaḥah* and its variations;
- usufruct-based contracts such as *ijārah* and its variations;
- equity-based contracts such as *mushārakah* and *muḍārabah* and their variations;
- loan-based contracts such as *qarḍ*; and
- service-based contracts such as *wakālah* and *wadīʿah*.

A review of all these Islamic contracts employed by IIFS to provide financing to their customers and build business on the assets side of their balance sheet indicates clearly that the economic outcomes of such contracts are similar to those achieved by different types of conventional FIs, such as banks, asset managers, brokerages, etc. In all cases, IIFS use one or more of these Islamic contracts to provide the required capital or financing support to their customers to sustain and/or grow their business enterprises. In such a case, the level of ML/TF risks associated with the products offered by IIFS do not arise from the Islamic finance contracts used by the IIFS and their execution. Rather, the ML/TF risks arise from the clients involved and their motives in entering a specific transaction with a FI, which is irrespective of whether or not the FI is an Islamic FI. All in all, the Islamic financing contracts and their usage, by themselves, do not appear to result in aggravating the ML/TF risks.

In the case of sale-based contracts such as *murābaḥah* and *salam*, the customers receiving financing are counterparties to the sale and deferred payment contracts entered into by the IIFS, but they are treated as customers of the IIFS on the other end of such transactions. These sale-based contracts require IIFS to possess the underlying asset, at least momentarily as in *murābaḥah* financing. There are concerns expressed about the involvement of such commodity trades in the execution of the financing transaction as posing an aggravated level of ML/TF risks, since trading assets and commodities at either profits or losses is a typical technique employed to obscure the source of funds or their destination by players indulging in ML or TF.

An analysis of the use of such sale-based contracts reveals a specific issue that supports the observation that the ML/TF risks are no more than those faced by conventional FIs providing similar financing. The specific aspect is the role of Islamic financial institutions in initiating and using these sale-based contracts to provide the financing sought by the customer. The related commodity trades or sale-based contracts are not trades initiated by or fictitiously executed by the client, as in the case of a typical ML/TF incident.

Similarly, in the case of profit/loss-sharing equity-based contracts such as *mushārakah*, the investment or financing is provided on the basis of a partnership agreement between the IFI and the owner of the business enterprise being financed. However, IIFS treat their business partners in all financing under such equity contracts as customers receiving financing support from them, just as a conventional bank would treat a borrower.[254]

The role of IIFS as partners in terms of risk sharing with their customers seeking financing or investment from IIFS obliges them to be more concerned about the integrity and legitimacy of their customers, as well as about the source of funds and the underlying assets and securities. Consequently, IIFS generally need to know their customers very well in terms of understanding their business activities, enterprise, risks, and their sources and uses of funding.

Islamic contracts based on leases, service provision or loans are much more similar to client relationships held by different types of conventional FIs. So, such cases naturally lend themselves to situations wherein the IIFS treat the parties receiving their service, loan or lease as customers, in much the same way that conventional FIs providing similar services would treat the parties receiving such services.

In addition, many of the Islamic finance contracts widely used for providing finance to customers are asset-backed and involve the real asset being financed as a matter of the contract used to make the financing. This involvement of the real asset being financed in the contract allows Islamic banks to ascertain the actual utilisation of the funds they provide, giving them a useful control for addressing ML/TF risks, in respect of use of funds and potential layering.

A detailed analysis of all the different categories of Islamic contracts primarily used by IIFS in providing Sharīʻah-compliant transactions clearly indicates that the parties receiving the products and services are always treated as customers and subject to all applicable regulatory requirements which include, but are not limited to, AML/CTF requirements. This is uniformly seen across all types of Islamic contracts, including the counterparties in sale-based contracts, lessees in *ijārah* contracts, partners in *mushārakah* and *muḍārabah* contracts, or recipients of service or assistance in *wakālah* or *qarḍ* contracts.

In some types of transactions, such as *sukūk* or structured financing, IIFS use legal structures including Special Purpose Vehicles, with the aim of offering Sharīʻah-compliant financial products or services. SPVs are corporate structures set up solely for the purpose of executing a specific financing transaction or debt offering. Although factors such as use of SPVs and other similar complicated corporate structures are normally seen as indicators of heightened ML/TF risk in the conventional finance domain, in the case of IIFS such factors are used to achieve the legitimate purpose of executing Sharīʻah-compliant transactions. More importantly, it is often the case that an IIFS designs and offers the required structures and they are not initiated or executed by the client, who could potentially be the beneficiary of any intended abuse through ML/TF. It is also important to note that SPVs and similar structures employed to execute *sukūk* issues are often managed or controlled by regulated international banks in their role as trustees. However, it should be added that SPVs that are established in offshore financial districts might pose additional risks to the ML/TF, and the standard setters and regulators should develop mechanisms to fully supervise these SPVs.

There is a perception among some external commentators that Hawala payment systems are linked to the Islamic finance industry. Such perceptions and similar security-related concerns about Islamic finance are usually the result of misinformation or a lack of understanding of Sharīʻah-compliant products and services. Although various features of Hawala make it highly vulnerable to ML/TF activities, Hawala is essentially not a Shari'ah-compliant financial service or product, nor is it offered by the Islamic finance industry. The Hawala payment system has no relation to Sharīʻah principles underlying the Islamic finance industry. Hawala is mainly an informal money transmission system which operates independently of any banking system, including those of Islamic banks. This has been corroborated by the FATF's report on Hawala in money laundering and terrorist financing,[255] in which no links have been cited between Hawala payments and Islamic finance.

4.2.10 The Element of Sharīʻah Governance in the Ex-ante, Execution and Ex-post Stages of Product Offerings

IIFS are subject to an additional layer of controls in the form of a Sharīʻah governance framework, which includes various aspects of reviews and controls, primarily aimed at ensuring effective compliance with Sharīʻah. The operation of Sharīʻah governance and its controls also involve reviews of the transactions and products dealt by IIFS to ensure that they do not facilitate unlawful

[254] The IMF Working Paper (2016), which is cited several times in this section, argues that the nature of the partnership-based Islamic contracts may pose extra MF/TF risks due to: (i) a potential conflict of interest between the institution and the client, which may render customer due diligence and reporting suspicious transactions more difficult; and (ii) the possibility of less reporting of illicit activities by the institution out of a fear that both side of the partnership could be held jointly liable.

[255] FATF (2013), The Role of HAWALA and Other Similar Service Providers in Money Laundering and Terrorist Financing, October.

activities, as this is a key element of Sharī'ah compliance. Money laundering and terrorist financing, being criminal offences in most member jurisdictions following the requirement specified in the FATF standards, are the kind of unlawful activities expected to be identified and whose related risks are controlled by the operation of the Sharī'ah governance systems and controls, in addition to the work done by AML/CTF systems and controls. It is useful to add here that Sharī'ah governance arrangements differ across countries, with some countries placing a high level of importance on national Sharī'ah Supervisory Boards while others rely on governance within individual IIFS. This divergence may have an influence on the contribution of Sharī'ah governance to the effectiveness of AML/CFT arrangements.

4.2.11 Role of the Compliance Department

The role of the compliance function in an IIFS in respect of ensuring compliance with all applicable laws, rules and regulations, including those pertaining to AML and CFT, is identical to the role of a compliance function in a conventional FI. The compliance function in an IIFS is expected to ensure a robust framework for compliance with required AML/CFT obligations by:

- establishing strong systems and controls, as well as adequate procedures for KYC/ CDD and transaction monitoring systems;
- providing adequate training to all staff, to equip them to identify and address AML/CFT risks in the course of their regular work; and
- implementing adequate monitoring systems to identify AML/CFT risks and meet relevant regulatory obligations.

As indicated earlier, these elements and their functioning are not materially different from those of conventional FIs. The compliance function in an IIFS is expected to review the processes and procedures employed, particularly in respect of the peculiarities in its processes related to Islamic contracts, and to ensure that any potential AML/CTF risks are addressed adequately. The Sharī'ah compliance responsibilities of the compliance function in an IIFS, which involve screening of the clients and their transactions, provide an additional layer of protection to address the AML/CFT risks in respect of transaction monitoring and the source of funds. The Sharī'ah screening provides a control to ensure the integrity of the transaction and that of the underlying trade or service which necessitates the payment, as well as an opportunity to assess the reasonableness of the price and terms of the transaction, which are essential controls for effective AML/CFT compliance, and to perform Sharī'ah screening so as to ensure that the utilisation of proceeds is permissible, which should not involve ML and FT.

4.2.12 Role of the Internal Sharī'ah Review Unit

It is normal for an IIFS to have an Internal Sharī'ah Review Unit (ISRU), which is expected to effectively review transactions and products and services dealt with, not only from the perspective of compliance with Sharī'ah but also from a wider perspective of adequate control of all aspects of an IIFS's operations to ensure that it is not involved in illegal activities, as well as to promote soundness and stability of the IIFS. The reviews by ISRU as part of its role in the Sharī'ah governance framework thus provides an additional layer of monitoring and controls to address potential ML/TF risks faced by an IIFS, in comparison to a conventional FI, which does not enjoy that benefit. Such reviews increase the probability of identifying suspicious transactions at the least, and also transactions potentially executed to abet criminal activities not limited to money laundering and terrorism financing. This additional compliance layer, which is a unique characteristic of IIFS, should be recognised as a credible deterrent to potential abuse of IIFS for ML and TF.

The ISRU and, eventually, the Sharī'ah board responsible for reviewing the ISRU's reports and for setting its mandate are also responsible for ensuring that the funds handled by an IIFS as part of its investment operations or the financing provided by it are not utilised to support business activities which are not Sharī'ah compliant. This also serves to provide a control point for the IIFS to review and determine the nature of activities supported by the proceeds of the transactions handled or financing provided and the source of funds received by the IIFS, which is similar to the aims of AML/CTF controls relating to source of funds and transaction monitoring.

The role and operation of various elements of the Sharī'ah governance framework provide additional controls to address some key elements of the ML/FT risks at different stages of business operations and/or transactions, ranging from the Sharī'ah compliance rules and requirements providing ex-ante controls on the nature of the activities supported or funds received.

4.2.13 IIFS Role of Islamic Finance in Financial Inclusion and AML/CFT Issues

The intrinsic nature and characteristics of some of the Islamic finance products in the financial services domain have clearly proved to be decisive advantages in advancing the goals of financial inclusion by appealing to the interests of those sections of society who could not afford to access the services provided by the mainstream financial services sector. This is well evidenced by the growing acceptance of specific segments such as microfinance and *microtakāful* provided by community banks and/or local banks. In Muslim-majority countries, these segments have been successfully delivered by conventional and Sharīʹah-compliant financial institutions involved in microfinance.

The FATF has helpfully highlighted the apparently conflicting impact of adopting an overly cautious approach to AML/CFT measures which can have the unintended consequence of stifling progress in achieving higher levels of financial inclusion. Among many of the IFSB member countries, this apparent conflict is witnessed in their growing microfinance sector. Having recognised the potential constraints due to this issue, the FATF has prepared guidance to provide support in designing and implementing AML/CFT measures that would facilitate countries to meet the goals of financial inclusion, without compromising on the effectiveness of AML/CFT measures. The FATF guidance aims to outline the flexibility offered by FATF standards, particularly in respect of the risk-based approach, allowing jurisdictions to design appropriate and effective AML/CFT regimes. Given the leading role being assumed by IIFS in many of the member countries to achieve financial inclusion goals, it is important to highlight this FATF guidance so that IIFS involved in microfinance can adopt measures that are risk-based and not restrictive.

Essentially, the FATF guidance allows flexibilities in different key areas of AML/CFT measures such as customer due diligence, record-keeping requirements, reporting of suspicious transactions, use of agents and internal controls. In CDD, the guidance allows for a "progressive" or "tiered" approach and simplified CDD, based on the level of ML/TF risks involved in that segment or for a particular client.

The FATF guidance also allows the retention of electronic records for CDD and the use of risk-based analysis for ongoing CDD and monitoring of suspicious transactions.

4.2.14 Conclusion and Moving Forward

The FATF recommendations as the global standard for AML/CFT regulation and for management of AML/CFT risks are applicable to all segments of the Islamic financial services industry, without any restriction or exemptions. As indicated earlier, FATF standards provide the basis for AML/CFT regulations and serve as a benchmark for managing AML/CFT risks faced by IIFS in almost all the member jurisdictions.

The IFSB member jurisdictions have made remarkable progress in achieving effective compliance with FATF standards, as indicated by the mutual evaluations and assessments carried by FSRBs or the FSAP teams from the IMF. The high level of progress achieved is reflected by the fact that almost all the member jurisdictions have achieved acceptable levels of compliance with FATF standards and/or are working with the FATF to implement measures to enhance their level of compliance.

In almost all such cases, wherein jurisdictions have successfully implemented measures to enhance their AML/CFT regime, including enactment of necessary legislation and establishing capabilities, the measures have been common to the IFSI and the conventional financial sector.

Overall, the ML/TF risks faced by the IIFS and Islamic finance sector are not fundamentally different from those faced by conventional FIs, both in terms of frequency of occurrence and impact. There is no identifiable reason to believe that the Islamic finance sector is more vulnerable to ML/TF risks, because of the peculiarities in its operations and the nature of products and services it provides to its clients in the financial services domain. The products and services offered by IIFS differ from those of conventional FIs mainly in terms of their contractual documentation and the processes and procedures involved in completing the relevant transactions.

The use of Islamic contracts to provide the required financial services and products does not allow or facilitate money laundering in any way or expose IIFS to any specific vulnerabilities in respect of ML and TF. The focus on ensuring the integrity of the clients, the identity of ultimate beneficiaries, the nature and origin of funds received/paid, and the legality of the underlying trade or business enterprise supported by the financial products offered by IIFS is identical to that adopted by conventional FIs to address these ML/TF risks. In comparison to conventional banks, IIFS are much better placed to identify and deter illegal transactions, including ML/TF activities, due to their active participation and knowledge of their customers, their reliance on asset-backed financing, and the role of Sharīʹah compliance reviews as an additional layer of controls.

The study has, however, also identified potential areas where more comprehensive research on the individual products and services offered by the IIFS, and their implications for the broader legal and regulatory framework for AML/CFT, would be warranted. Among the potential areas for further analysis include developing methods, trends and typologies in Islamic finance arising from the nature of the contractual relationship among the IIFS and their customers. That said, lack of data is an important impediment to undertaking the further analysis. Therefore, the new study, complemented by a survey from IFSB member jurisdictions on the unique elements of IIFS's operations from AML/CFT perspectives, developments made in improving their legal and supervisory infrastructure, and data collected by them on any specific instances of Sharīʹah-compliant transactions, would make an important contribution to this subject. As mentioned earlier, the IFSB has planned to conduct this research as a part of its work plan identified in its Strategic Performance Plan 2016–2018.

4.3 ASSESSING REGULATORY CONSISTENCY IN THE IMPLEMENTATION OF GLOBAL PRUDENTIAL STANDARDS

4.3.1 Background

The evolution of regulatory standards and international regulatory frameworks addressing various segments of the Islamic finance sector has progressed steadily over the past two decades owing largely to the efforts of global standard setters. This progression has, in general, kept pace with the evolution of the Islamic finance industry and thus has served the needs of the industry very well, in terms of appropriate regulatory standards and enhancing trust in the sector. Having established the regulatory standards, it is critical to ensure their effective and consistent implementation in all the markets where Islamic finance plays a significant role.

The importance of full and consistent implementation of international standards was amply demonstrated during the global financial crisis. Following that crisis, a concerted programme to ensure consistency and completeness in implementation of global standards was conceived as a critical component of the overall regulatory reform initiative by the Financial Stability Board. This rationale applies to all segments of the financial services sector and equally to the Islamic finance sector.

This section discusses the efforts being made by key global standard setters to achieve consistency of implementation. It starts with a discussion on the need for, and the importance of, regulatory consistency assessment programmes, and a description of the role of the FSB in driving this as part of its regulatory reform initiative. A discussion then follows on the efforts of the three primary global standard setters in the financial services domain, including the efforts of the BCBS – reflecting its leading role in this domain – to develop a large body of work on relevant processes and methodologies. The section then discusses the efforts of IOSCO and the IAIS, which, in the absence of global capital and liquidity standards for their areas, have dealt with assessment in a less numerical manner. The section also discusses the impact of regulatory consistency assessment programmes for the IFSI and its constituents, and attempts to identify the aspects of the ISFI that could benefit by the application of such programmes.

4.3.2 Regulatory Consistency Assessments before the Financial Crisis

Prior to the GFC, the monitoring of implementation and the evaluation of regulatory regimes was limited in scope and intensity. The BCBS had a limited programme of assessing the implementation efforts in key jurisdictions through surveys. This form of assessment was supplemented largely by the evaluations carried out by IMF–World Bank teams in the form of Reports on Observance of Standards and Codes assessments forming part of Financial Sector Assessment Programmes coordinated and executed by the IMF.

In the banking sector, the Financial Stability Institute (FSI), which was set up jointly by the Bank for International Settlements and the BCBS in 1999 to assist financial-sector supervisors around the world in improving and strengthening their financial systems, carried out periodic surveys on subjects of supervisory interest and shared the findings with the supervisory community. In 2004, the FSI conducted a survey on Basel II implementation, which was followed by updates in 2006, 2008 and 2010. These surveys were limited to collection of information on the implementation of the key elements of various regulatory standards such as Basel II and publishing the collected data. They did not involve any assessment of the completeness of implementation or its consistency with the relevant global standards.

There were some horizontal reviews carried out by the BCBS across jurisdictions, focusing on specific topics such as market risk. These thematic reviews were largely quantitative in nature and were not successful in identifying or highlighting lack of consistency in outcomes across jurisdictions.

4.3.3 Regulatory Reform since the GFC and the Role of the FSB

The significant levels of disturbances to global financial stability and the high level of costs inflicted on the public sector in many countries by the GFC motivated the global political leadership concentrated in the G-20 to focus on making the global financial markets safer by forcing financial institutions to operate in a sound manner with prudent risk management. As part of their efforts to achieve these aims, the G-20 leadership concentrated their efforts on strengthening the global regulatory frameworks for the financial services sector.

As a first step, the then-existing Financial Stability Forum was strengthened, and given a broader mandate to take all measures to promote financial stability, when it was replaced with the current FSB in April 2009. The FSB has since assumed a key role in promoting the reform of international financial regulation. Its core objective is to promote global financial stability by coordinating the development of regulatory, supervisory and other financial-sector policies. In this role, the FSB has maintained its focus on implementing the regulatory reform initiatives within predefined timelines and vigorously pursued the tasks it set out for the various global standard setters such as the BCBS under those initiatives.

The FSB operates through a three-stage process comprised of processes for the identification of systemic risk in the financial sector, for framing policy actions that can address these risks, and for overseeing the implementation of agreed policies.

The FSB's directives reflecting its strategic priorities and the wishes of the G-20 have been the dominant influence in setting the agenda of standard setters for component sectors such as the BCBS for banking and in determining their strategic priorities, including the thrust and intensity of efforts in implementation. Some of the most notable changes in the approach towards financial regulation since the entry of the FSB have been an intensive focus on establishing robust standards, ensuring coverage of all segments of the global financial markets and, more importantly, a strong emphasis on ensuring consistency in implementation of regulatory standards across national jurisdictions. The aspect of focusing on achieving the desired regulatory outcomes effectively, by means of ensuring consistency in the implementation of regulatory standards, through the RCAP framework has been a new dimension in the global regulatory architecture following the global financial crisis.

In the wave of regulatory reform initiatives that followed the GFC, the RCAP assumed critical importance, driven by the emphasis laid on it by the architects of the regulatory reform initiative, the G-20 and the FSB. The FSB identified full and consistent implementation of regulatory standards within an internationally agreed time frame as an essential prerequisite for strengthening the resilience of the financial system, improving market confidence in regulatory standards and promoting a level playing field. In the initial phases of the regulatory reform programme, the FSB focused its efforts in respect of RCAP on the banking system – in particular, on the consistent implementation of the Basel III framework across jurisdictions given the focus on implementation of the Basel III framework as a key global regulatory reform priority.

As part of its efforts to strengthen the implementation of global standards, the FSB established a Standing Committee on Standards Implementation (SCSI), which was mandated to coordinate and oversee the monitoring of the implementation of agreed financial reforms and its reporting to the G-20. This includes reporting on progress in implementing international financial standards and other policy initiatives, conducting peer reviews of FSB members, and encouraging global adherence to prudential regulatory and supervisory standards.

In order to strengthen the coordination and effectiveness of implementation monitoring, the FSB, in collaboration with standard setters such as the BCBS, established a framework in October 2011, the Coordination Framework for Implementation Monitoring (CFIM). The CFIM distinguishes between priority areas, which undergo more intensive monitoring and detailed reporting via periodic progress reports and peer reviews, and other areas of reform. The current list of priority areas agreed by the FSB includes, at the top of the list of a select six focus areas, the Basel III framework. The other areas prioritised by the FSB are OTC derivative market reforms, compensation practices, resolution frameworks, policy measures for systemically important financial institutions and shadow banking.

The FSB designates a specific body, either an FSB working group or the relevant standard setter, to undertake the monitoring and reporting of implementation progress in each priority area. The FSB's SCSI plays a coordinating role within the FSB in monitoring implementation efforts and consults with relevant bodies as needed to ensure that the scope and approach of reporting – particularly for priority areas – are comprehensive and rigorous. In regard to the monitoring of the implementation in its most critical reform area, the Basel III framework, the FSB has mandated the BCBS.

Following the FSB's emphasis on consistent implementation of regulatory reform initiatives across jurisdictions, all the three main global standard setters in the financial services domain set about establishing their own programmes for assessing and monitoring consistency of implementation of regulatory reform initiatives in their sector. This included initiatives by the BCBS, IOSCO and the IAIS, though the BCBS led the efforts in this area consistent with the FSB's emphasis on regulatory consistency in the banking sector.

4.3.4 Banking Regulation: Concept and Need for RCAP

National regimes for banking regulation, including laws, rules and regulations, are based on global benchmark standards such as the Basel III framework for banking regulation. The development of these standards was premised on the expectation that all members of the standard setter would implement the standards both in letter and spirit. This is reflected in the charter of the BCBS, which mandated its members to implement and apply its standards within specified timelines.

The implementation of global benchmark standards in national jurisdictions often involves some level of customisation to reflect the legal frameworks and industry structure existing in a particular country or jurisdiction. The flexibility offered by the scope to customise was intended partly to:

- accommodate the idiosyncratic features of a national banking market and the nature of its legal framework; and

- give legal underpinning to the global standards such as Basel III which do not have the force of law inherently.

However, this customisation should not extend to a level at which the fundamental components of the global standard and its core norms are not transposed effectively in the national legislation, thereby hampering the ability to achieve the intended goals of the global standard. National regulatory standards incorporating significant deviations from the global standard cause potential regulatory arbitrage opportunities and encourage market participants to pursue strategies and make business decisions to exploit such opportunities even though that might lead to weaknesses in their financial position and unsound operations.

For example, material differences in the implementation of the Basel II framework in important markets in the past created opportunities for banks to assume risks with lesser capital requirements than required by Basel II, which provided them with significant competitive advantages in the international banking market. This encouraged a few banks to move their risk exposures to such jurisdictions and achieve a lower level of risk-based capital as well as higher levels of leverage, both of which are imprudent practices leading to a relatively weaker financial position. Such material deviations in implementation also undermined the level playing field for banks in the international market and could also potentially lead to retaliatory measures by some regulators to protect and bolster their banks.

Ensuring consistency in regulatory standards and their effective implementation across jurisdictions is an essential prerequisite for maintaining the trust and confidence of markets and consumers in the global standards, as well as in the financial institutions to which they apply. This is relatively more relevant for countries that have opened up their markets to foreign financial institutions and to financial institutions operating across international borders. Failure to ensure consistency in regulation erodes the credibility of global standards and exposes the financial system to potential vulnerabilities in respect of the adoption of imprudent operating practices driven by regulatory arbitrage opportunities and consequent weaknesses in financial institutions, leading to lack of resilience in the financial system. These trends could potentially aggregate or cause material impairments to global financial stability.

The RCAP adopted by the BCBS is a distinct initiative aimed at ensuring consistent implementation of its global capital and liquidity standard for banks, the Basel III framework. Given the nature of the prudential norms forming part of the Basel III framework, such as the capital charge calculations and liquid asset definitions, the implications of significant relaxations (or easier norms) in the implementation of Basel III in national regimes could cause material competitive advantages to banks operating in those countries. Alternatively, the banks operating in those countries could assume more risks for the same level of capital as compared to banks with tighter implementation of the Basel III framework, which implies a higher level of systemic risk for such countries.

The occurrence of such competitive advantages due to easier regulatory standards also has a punitive effect on the attractiveness of markets adopting the right implementation of Basel III, as well as an adverse impact on the profitability of their banks. It is essential to preclude such punitive impacts to maintain the credibility of global standards and to encourage consistent implementation so that the intended objectives of the global standard can be achieved.

Although the BCBS has taken the lead in establishing a robust and dedicated consistency assessment programme for the banking sector covering all its member jurisdictions, similar regulatory consistency assessment initiatives addressing Basel III or its European implementation (CRD IV) have been established and pursued by other institutions such as the European Banking Authority (EBA), which is responsible for banking regulation over most of continental Europe. This section describes in detail various aspects of the consistency assessment programme of the BCBS while also providing a summary overview of a similar programme employed by the EBA.

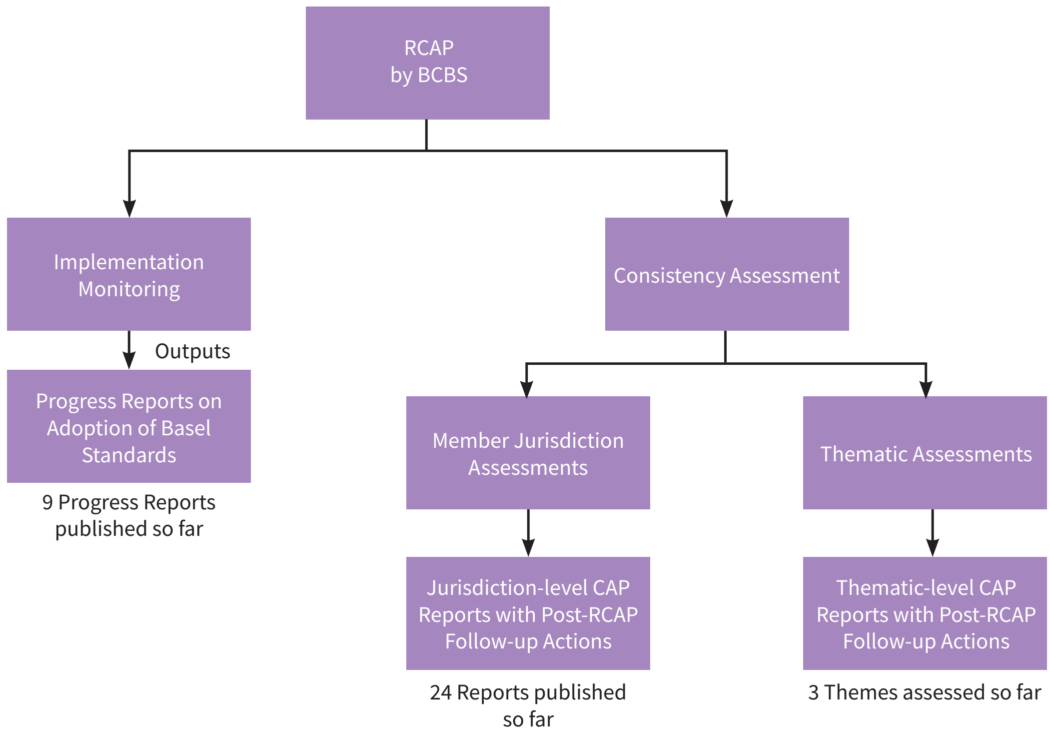
4.3.5 BCBS

Given the increased relevance of regulatory consistency to banking regulation, and particularly that of its prudential regulation and the FSB's emphasis, the BCBS established its comprehensive RCAP in 2012. The RCAP programme consists of two distinct, but complementary, components:

- RCAP monitoring component that focuses on monitoring the timely adoption of Basel III standards; and
- RCAP consistency assessments aimed at assessing the consistency and completeness of the adopted standards, including the significance of any deviations in the regulatory framework.

RCAP "consistency assessments" include both assessments of the consistency of local regulatory regimes in individual jurisdictions with that of the Basel III framework, and thematic assessments of specific areas of the Basel III framework across multiple jurisdictions to analyse and assess the regulatory outcomes achieved. While the RCAP monitoring component and the jurisdictional consistency assessments focus almost entirely on domestic rules and regulations, the thematic assessments are intended to assess the effectiveness of supervisory implementation at the level of FIs along with the corresponding industry and supervisory practices. These thematic assessments are aimed at ensuring consistency of outcomes in specific components of regulations, such as those pertaining to calculation of risk-weighted assets in the banking book and trading book. The thematic assessments are expected to be completed with the help of detailed data collected from the banks and FIs (see Diagram 4.3.5.1).

Diagram 4.3.5.1
RCAP Consistency Assessments



The transposition of the Basel III framework into domestic regulations is monitored on a semi-annual basis based on information provided by each jurisdiction with the aim of ensuring implementation of Basel III within agreed timelines. The implementation monitoring work is focused on the timelines, while the assessment of the effectiveness and consistency of implementation falls within the responsibility of the RCAP programme. Both the implementation monitoring efforts, and the RCAP assessment exercises involving the jurisdictional and thematic assessments, initially focused on the adoption of the Basel III risk-based capital standard, but has since expanded to cover the adoption of requirements for global and domestic systemically important banks, the liquidity coverage ratio and the leverage ratio.

In addition, the FSI continues to carry out surveys on progress in implementation of regulatory standards. In 2013, the FSI conducted a survey to check the status/plans regarding the implementation of Basel II, 2.5 and III in jurisdictions falling outside the membership of the BCBS and that of the European Union. The methodology used in the survey was similar to that adopted by the BCBS, and the results of this survey in 2013 were published. In line with the 2013 approach, the FSI is publishing the results of its 2015 survey covering 98 non-BCBS/non-EU jurisdictions. The survey considered 20 responses from OIC member countries, four of which have implemented substantially the Basel II standard, nine of which have partially implemented it, and seven of which have not implemented it. However, these surveys continue to be focused on collection and publication of aggregate data on the status or progress of implementation of various key components of Basel III and do not attempt to carry out an assessment of the completeness of implementation, nor of its consistency with the Basel III standards.

The reports coming out of the monitoring component of the RCAP which are aimed at implementation monitoring are published on a six-monthly basis. The results of the consistency assessments are published as and when the consistency assessments are completed for each of the jurisdictions.

The progress reports provide the outcomes of the implementation monitoring exercise using a four-step classification of the progress in adoption as follows:

1. Draft rules or regulations not yet published.
2. Draft rules or regulations published, but no final rules published yet.

3. Final rules in place but not yet implements by FIs.
4. Final rules in place and also implemented by Fis.

In addition to these, the progress report provides a colour-coded grading system to reflect the progress of implementation, particularly for those components of Basel III for which the implementation deadlines have already elapsed.

In addition to its half-yearly reports, the BCBS regularly updates the G-20 on members' progress towards implementation of the Basel III framework. These progress reports to G-20 also provide information on the BCBS's efforts to improve consistency in capital requirements, the harmonisation of regulations across member jurisdictions, and the steps taken to reduce variance in implementation practices.

The BCBS has published nine progress reports so far. In its latest report, published in October 2015, the BCBS reported that all 27 members of BCBS have implemented the risk-based capital component of Basel III, while all but two of the members have implemented the LCR rules. Currently, most of the members of BCBS are working on implementation of the leverage ratio and other remaining components of the Basel III framework.

4.3.6 Assessing the Consistency of Implementation of the Basel Standards

This component of the RCAP focusing on assessment of the consistency of implementation of the Basel standards and, in particular, the Basel III framework, complements the processes involved in RCAP's monitoring component focused on the pace of implementation of the Basel regulatory standards. While the monitoring processes are primarily off-site in nature and depend on collection of required data from members by way of specific questionnaires and surveys, the consistency assessments involve a much higher level of engagement, including direct interactions and visits to the jurisdiction being assessed. Assessments review how far domestic regulations in each member jurisdiction[256] are aligned with the minimum requirements defined under the Basel III framework and other BCBS standards.

The scope of these reviews includes all domestic laws, rules, regulations, guidelines or any other documents implementing Basel III and other Basel standards in assessing the completeness and consistency of implementation. A necessary condition for considering an element of a regulatory regime for the purpose of this assessment is that the relevant element is deemed by law or in practice as binding on banks and the supervisory authorities. In cases where there are draft rules or any non-binding pieces of regulatory framework which are intended to be subsequently replaced by binding legislation, such draft rules or non-binding elements may be used as part of the RCAP consistency assessment.

The Basel Committee's jurisdictional assessments forming part of the RCAP, as referred to earlier in this section, review the extent to which domestic prudential and capital adequacy regulations in each member jurisdiction are aligned with the minimum regulatory standards specified as part of the Basel III framework. The assessments examine the consistency and completeness of a jurisdiction's adopted standards, including the prudential significance of any deviations in the regulatory framework.

To ensure that the internationally active segment of the domestic banking system is in line with the letter and spirit of the relevant Basel standards, the assessments highlight the current and potential impact of deviations on the overall regulatory environment. This provides transparency to member jurisdictions of cross-jurisdictional differences and allows jurisdictions to initiate corrective measures, as appropriate, to strengthen their regulatory regimes and improve their functioning.

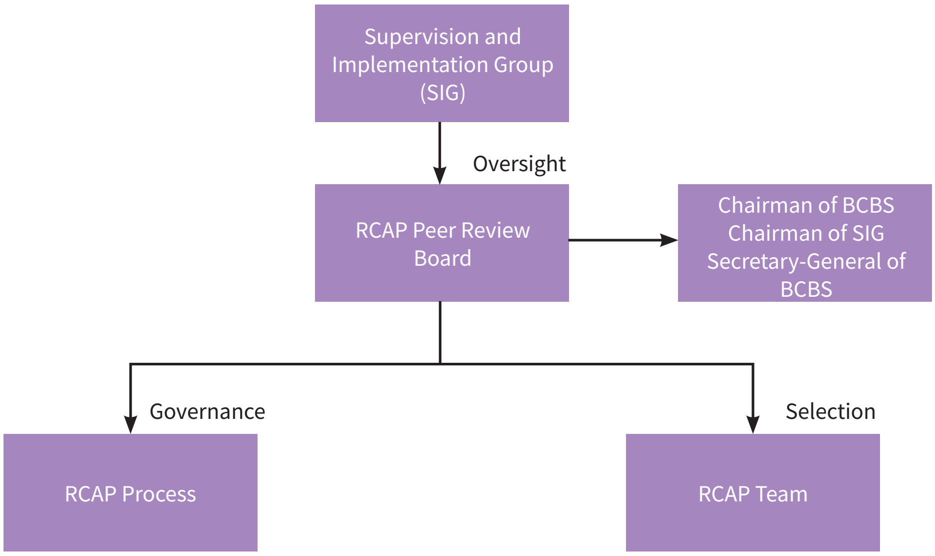
The RCAP programme envisages consistency assessments of all elements of the Basel III framework and other Basel standards. The initial assessments focused on capital-related regulations in the Basel III framework, including Basel II, 2.5 and III. All jurisdictions are expected to be assessed in respect of implementation of the various Basel standards and Basel III. However, initial priority is being given to countries with G-SIBs and members of BCBS.

The consistency assessments under the RCAP programme are undertaken by technical experts from other member jurisdictions of BCBS, considering the specialised nature of the subject matter and the need for relevant skills and expertise. In order to achieve a high level of objectivity and rigour, these assessments are designed as "peer reviews" and BCBS aims to ensure appropriate balance in composition of the assessment teams. The governance around the RCAP assessment process and its outcomes is provided by the RCAP Peer Review Board (PRB), with oversight and feedback from the Supervision and Implementation Group (SIG) of BCBS. The process requires the BCBS to finalise the outcome of RCAP assessments on the basis of consensus. The PRB, which is directly responsible for the governance and control of the RCAP assessments, consists of the Chairman of the BCBS, the Chairman of the SIG and the Secretary-General of the BCBS (See Diagram 4.3.6.1).

[256] The BCBS membership includes Argentina, Australia, Belgium, Brazil, Canada, China, European Union, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States as full members. Chile, Malaysia and the UAE are observer members of the BCBS.

Abstain from advanced approaches – BCBS View
In some cases, given the state of financial systems, jurisdictions may choose not to adopt some or all of the advanced approaches of Basel III for the measurement of risks. A distinct choice by the BCBS to deal with jurisdictions which have consciously decided not to adopt advanced approaches of Basel III framework in consideration of the stage of evolution of their banking industry and/or the nature of risks assumed by their banks is very relevant to the IFSB member jurisdictions. As part of the RCAP assessment of provisions relevant to such advanced approaches, the BCBS has decided to consider the relevant provisions as non-applicable for such jurisdictions and not assess them as non-compliant.

Diagram 4.3.6.1
RCAP Assessment Flow Chart



4.3.7 RCAP Governance

Presently, the assessment methodology is based on the following broad elements:

- Review of consistency and completeness of the adopted standards (i.e. all relevant Basel provisions have been adopted within the context of each member jurisdiction);
- Identification of gap or divergence from the Basel standard based on its current and potential prudential impact;
- domestic idiosyncrasies or limitations are not allowed as premises for exceeding the scope of national discretion specified within the Basel framework;
- domestic measures that go beyond Basel's minimum requirements do not compensate for inconsistencies or deviations identified elsewhere;
- limiting the coverage to regulatory issues and avoiding consideration of second-order effects such as those on systemic risks, competitive practices, or impacts on consumer, such as inclusion or quality;
- Assessment of the comparability of results delivered by local rules as part of specific thematic assessments; and
- the supervisory effectiveness of enforcing a regulatory regime is left for other assessment programmes such as the assessments of Basel Core Principles conducted under the FSAP, or those carried out by the Committee as part of its other "peer reviews" on supervision issues, or the broader reviews conducted by the FSB.

In its November 2015 progress update to the G-20, the BCBS reported that the BCBS level 2 assessments under RCAP in respect of risk-based capital regime have been completed for almost all the members of BCBS, while the assessments of implementation of the LCR regime continue. The BCBS has also observed its satisfaction in the role of RCAP in assisting jurisdictions to actively amend areas of material inconsistency from the global Basel III standard. For example, in 2015, the BCBS has published reports citing detailed actions taken by Brazil, China, Japan, Singapore and Switzerland to address findings in their RCAP assessments.

4.3.8 Thematic Assessments (Assessing the Consistency of Regulatory Outcomes – Study of Risk-weighted Assets)

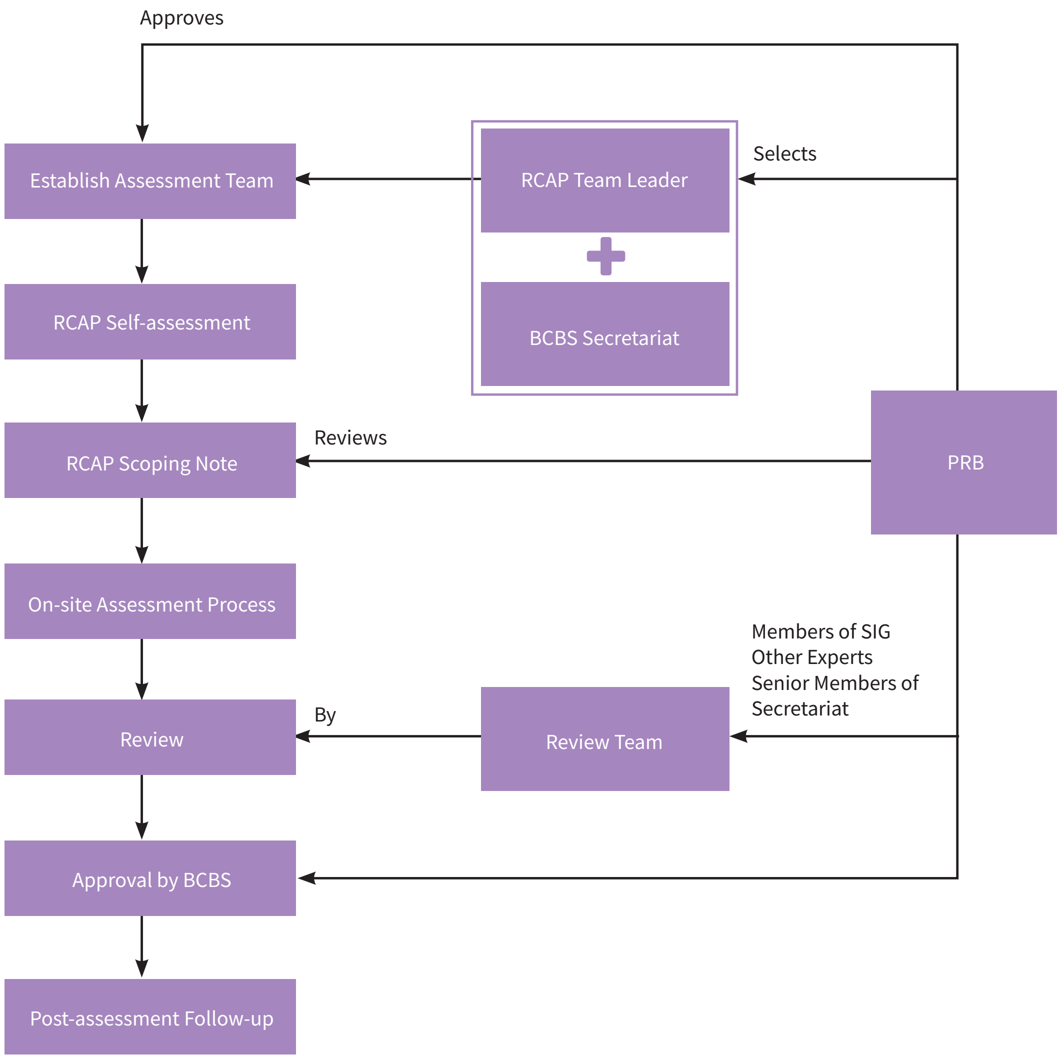
The BCBS's assessments of regulatory outcomes seek to ensure that the capital adequacy ratios and other prudential measures calculated by banks are consistent across banks and across jurisdictions. The aim is to determine that the differences, if any, are predominantly due to differences in risks assumed and not to practices and methodologies employed in risk measurement. This segment of the consistency assessment extends the BCBS's assessments of the implementation monitoring and jurisdiction-level assessments of consistency – both of which focus on national rules and regulations – to implementation at the individual bank level.

The BCBS's initial focus in this segment is on the calculation of risk-weighted assets (or the denominator of the Basel CAR) by banks from various jurisdictions. Variations in the application of the standards and calculation methodologies specified in the standards have, in the past, led to discrepancies in the capital ratios calculated. The assessments in this segment aim to distinguish variations in RWAs that are risk-based (i.e. due to differences in underlying risk at the exposure/portfolio level) from those which are practice-based (e.g. due to model selection or calibration of model parameters, exercise of judgement, or application of supervisory discretion).

The BCBS has established two expert groups, one group reviewing the calculation of RWAs for credit risk in the banking book and the other the calculation of RWAs for market risk in the trading book. These groups have been assessing whether there are material inconsistencies in the way banks calculate RWAs, leading to variations in the eventual RWAs calculated for a benchmark portfolio of exposures. Following the work of these groups, the BCBS has published three reports on the variations in RWA calculations among banks in the areas of banking book, trading book and counterparty credit risk.

The findings from thematic assessments of the RCAP consistency assessments focusing on analysis of outcomes have contributed significantly to the BCBS's ongoing standard-setting work. For example, the analysis of RWA in both the banking books and trading books of banks following the implementation of Basel III across jurisdictions has contributed significantly to the strategic review of the RWA framework conducted by the BCBS.

Diagram 4.3.8.1
RCAP Assessment Process



4.3.9 RCAP Process

As an initial preparatory step for an RCAP assessment, all jurisdictions need to complete the RCAP questionnaire, save for those that have already undergone an RCAP assessment or are currently undergoing one.

In addition to the completion of the RCAP questionnaire, the individual jurisdictions are expected to carry out a preliminary self-assessment almost on the same lines as that of the official RCAP assessment. This may involve significant effort on the part of the relevant regulator, but it offers an opportunity for the jurisdiction to describe in detail any specific structural factor or idiosyncrasy of its market which needs to be considered in carrying out the consistency assessment under RCAP.

4.3.10 RCAP Assessment Questionnaire

The PRB as the body responsible for organising and executing the RCAP assessments chooses an RCAP team leader. Potential RCAP team leaders are senior supervisors with significant supervisory and regulatory experience in the international domain, as well as a deep understanding of the functioning of internationally active banks and international financial markets.

The BCBS secretariat, in consultation with the chosen team leader, constitutes an assessment team, drawn from a panel of experts volunteered by the member jurisdictions and maintained by the secretariat. The team's size and composition will vary depending upon the jurisdiction being assessed. However, every assessment team will have designated staff members from the BCBS secretariat.

The team leader is responsible for leading the discussions with the BCBS Secretariat – and, if required, with the PRB – on any strategic, interpretative and methodological issues that may arise during the course of the RCAP consistency assessment. The PRB reviews the composition of the constituted team and approves the team. In approving the team, the PRB ensures that it enjoys independence with respect to the assessed jurisdiction. Jurisdictions that have G-SIBs are reviewed on their G-SIB framework simultaneously by a single assessment team, which is composed of members drawn from jurisdictions that are not being assessed.

The main criteria specified by the RCAP programme for selection of the team are:

- expertise covering all components of the Basel framework, particularly Basel capital and LCR framework;
- the ability to work both as primary and secondary reviewers within the team; and
- appropriate geographical diversity and language skills, with a balance of membership across member jurisdictions and different financial systems.

Alongside the establishment of the assessment team, the PRB also sets up a review team for the assessed jurisdiction. The review team is drawn from the SIG, with a minimum of two members from the SIG, other experts from the Committee, particularly the Policy Development Group (PDG), and a senior member of the Secretariat.

4.3.11 Establishment of the RCAP Assessment Teams

A typical RCAP assessment requires about six months from the time the team leader notifies the scope of the assessment to the jurisdiction and requests the necessary data and information. The team leader is expected to prepare a detailed schedule with associated timelines for the assessment in coordination with the BCBS Secretariat and the jurisdiction being assessed.

4.3.12 Off-site Assessment Phase

Following the submission of the completed RCAP questionnaire by the jurisdiction, the assessment team completes an initial review of the responses submitted and prepares an RCAP scoping note setting out the scope, methodology and other structural aspects of the jurisdiction relevant for the assessment. The scoping note identifies preliminary areas of focus and potential data requests, as well as the agreed timeline and process for the assessment. A copy of the scoping note is sent to the PRB, the review team, and the assessment counterparts in the jurisdiction undergoing the assessment.

The off-site review is based on work undertaken by primary assessors and secondary reviewers, and relies on conference calls and face-to-face discussions among the team members. The assessment team reviews the response to the RCAP questionnaire, and makes use of other material relevant to banking regulation in the jurisdiction, including external reports, assessment of the Basel Core Principles, and available data on the banking sector's structure and composite balance sheet. The off-site review should result in a provisional list of deviations that forms the "baseline" assessment for the materiality analysis.

4.3.13 On-site Assessment Phase

Onsite reviews are conducted as part of the assessment process of risk-based capital and LCR standards. Given its nature and scope, the G-SIBs assessment is conducted mainly off-site, relying on information submitted by the assessed jurisdictions. The on-site visit, which normally extends over a workweek, provides the basis for finalising the materiality analysis. The assessment team meets with the relevant technical staff of the supervisor of the jurisdiction concerned. The team may also meet with representatives from the banking industry, and other relevant market participants, including auditors and accounting firms.

The on-site visit results in a draft RCAP assessment report that is presented to the supervisory authorities of the jurisdiction being assessed, as a preliminary assessment subject to further review by the RCAP review team.

4.3.14 Review, Approval and Publication Phase

The RCAP assessment process includes a thorough review marked by sufficient levels of accountability to complement the assessment work. The review team needs to review and agree on the draft report before it is submitted to the SIG and PRB for final review. The review team also reports to the SIG about material findings or policy issues arising from the RCAP. The comments and suggestions from the SIG are communicated to the PRB before it approves the report for submission to the Basel Committee.

The BCBS itself has the final responsibility for approving the assessment report, which needs to be approved by consensus. The representatives of the assessed jurisdiction are not allowed to participate in any decision making, though their views are reflected in a separate section of the report. After the BCBS's formal approval, the assessment report, including a specific response from the assessed jurisdiction, is published on the BCBS's website and is sent to the FSB. The main conclusions of the assessments completed are periodically summarised and included in the BCBS's progress report on Basel III implementation with a view to providing a comprehensive view of consistency of implementation across jurisdictions.

4.3.15 Post-assessment Follow-up

The BCBS continues to monitor the progress achieved by assessed jurisdictions in addressing the deficiencies identified in the assessments and/or to enhance their regulatory regime. In cases, where substantial regulatory developments or changes have been enacted which could have a material impact on existing assessments, the BCBS intends to update these assessments within a reasonable time frame. The BCBS may also update assessments when it concludes any revisions or final adjustments of certain components of Basel III.

4.3.16 Assessment Methodology

4.3.16.1 General Approach

The general approach underlying the methodology for assessment of compliance with the Basel standards primarily involves two components, one focusing on the completeness of the regulations implementing the standards and the other concentrating on the consistency of the regulations with the Basel standards.

The assessment of completeness entails a comparison of the regulations of the jurisdiction with the corresponding Basel standards to ascertain whether all the required provisions of Basel III have been adopted. The consistency assessment involves a determination of whether there are any differences in substance between the regulations in place and the relevant Basel standards, independent of the format of the regulations.

The assessment process also aims to achieve an understanding of the rationale for the identified divergences in the local implementation of the Basel standards, in terms of the idiosyncrasies of the market and industry structure in that jurisdiction as well as other drivers such as public policy choices in areas including financial inclusion and thrust on Islamic finance.

The process assesses local regulations that are more stringent than the minimum requirements specified by Basel III as being compliant with the Basel standards. However, tougher regulations in one aspect of the regime will not be considered as compensating for inconsistencies or gaps identified in other parts of the regime, unless the tougher elements directly address the identified divergences from standards or gaps.

The assessment process results in a report consisting of an overall assessment of the compliance of the jurisdiction's regulation with Basel III and assessments of the compliance of the jurisdiction's rules for each of the key components of the framework, which include:

- Risk-based Capital Standards
    - Pillar 1 – Minimum Capital Requirements
    - Pillar 2 – Supervisory Review Process
    - Pillar 3 – Market Discipline
- Basel Liquidity Coverage Ratio
- Basel framework for G-SIBs – additional loss absorbency requirements
- Basel framework for D-SIBs (not graded).

The recently issued RCAP Handbook for Jurisdictional Assessments (March 2016) has further refined the assessment methodology to include provisions for possible amendments or extension to the assessment. In an instance where methodological questions arise, the BCBS Secretariat and the team leader, in consultation with the BCBS Head of Basel III Implementation, shall propose a course of action to the PRB for discussion. Based on the proposal, the PRB will decide whether to sign-off on the proposed process or criteria for the purposes of the current assessment, or determine a more appropriate course of action. The PRB could also obtain feedback from the SIG if there is sufficient time before submission of the draft assessment report to the BCBS; otherwise, it can directly raise the matter to the

BCBS. The revised handbook also includes the approach for assessing banks that have implemented the revised Basel standards, which was not covered in the previous handbook.[257]

4.3.16.2 IOSCO's Implementation Assessment Programme

Following the intensive focus of the FSB in ensuring consistent and full implementation of the agreed reform measures forming part of the global regulatory reform agenda, and consistent with similar moves by the BCBS, IOSCO has also established its own framework for implementation monitoring.

IOSCO's efforts in this regard are led by its Assessment Committee (AC), which was established in February 2012 by the Executive Committee (EC) of IOSCO as an outcome of its strategic direction review.

4.3.16.3 Objectives

The AC is responsible for developing and delivering programmes to assess implementation of IOSCO's Objectives and Principles of Securities Regulation ("IOSCO Principles") and other IOSCO standards and policies among IOSCO member jurisdictions. The objectives of such programmes are to encourage full, effective and consistent implementation of principles and standards across IOSCO membership as part of efforts to ensure investor protection, and fair and efficient markets, and to reduce systemic risk globally. These objectives are consistent with the aims of the implementation monitoring initiatives coordinated by the FSB and are aimed at reducing opportunities for regulatory arbitrage.

4.3.16.4 Activities of Assessment Committee

The AC achieves its objectives by carrying out jurisdiction-specific reviews and thematic reviews of the implementation of IOSCO core principles and standards. The AC's core responsibility is the conduct of these reviews. The AC employs jurisdiction-specific reviews to assess the implementation in jurisdictions whose securities regulation regimes have not been subjected to assessments under the FSAP programme. The AC defines the scope of these reviews and primarily relies on self-assessments prepared by the regulators to evaluate the status of implementation and prescribes an action plan to address any identified gaps.

The jurisdiction reviews provide an independent and objective evaluation of the status of implementation to the concerned regulatory authorities and indicate the progress achieved by them. These reviews also provide an action plan to address material deficiencies and challenges to implementation, and the findings of these reviews are useful in supporting the case for required legislative/policy and/or regulatory changes. Overall, these reviews have been effective in improving the level and effectiveness of implementation of IOSCO Principles and standards across its membership.

In addition to the jurisdiction reviews, the AC also carries out thematic reviews which assess the implementation of a specific set of IOSCO Principles and/or IOSCO standards across a group of IOSCO member jurisdictions. These thematic reviews aim to identify gaps in implementation, variations in implementation approaches, examples of good practice, and challenges faced by regulators in implementation. The AC develops the scope and terms of reference for each thematic review.

The thematic reviews assist the regulators in understanding the relative merits and demerits of any identified differences in implementation approaches and identify best practices in implementing the IOSCO Principles and standards. Thematic reviews also help to identify standards that are difficult to implement and need to be revised to facilitate effective implementation in a practical manner. The AC also provides technical assistance wherever required to jurisdictions that face challenges in achieving consistent implementation of IOSCO standards.

4.3.16.5 Follow-up Action

The AC aims to deliver constructive assessments of the implementation of IOSCO Principles and standards, which will also include detailed action plans for addressing material deficiencies or inconsistencies identified in the reviews. In case of jurisdiction reviews, the AC will set out a recommended road map specifying the areas for improvements in relation to the principles or standards wherein the jurisdiction has failed to achieve an assessment grade of 'Fully Implemented'. The road map recommended is customised on the basis of the jurisdiction's needs and peculiarities, and prioritises improvements that are most material and significant in terms of the IOSCO Principles and standards.

4.3.16.6 Implementation Monitoring by IAIS

The IAIS has also established its own standards implementation monitoring mechanism, in a way similar to those of BCBS and IOSCO. This mechanism enables the IAIS to fulfil the strategic priorities of the FSB in respect of ensuring full and effective implementation of regulatory standards and to meet the directives issued by the FSB in this regard.

[257] https://www.bis.org/bcbs/publ/d361.pdf.

The IAIS conducts thematic assessments of implementation of its supervisory standards by its member jurisdictions. The IAIS also publishes summary findings from these assessments, which provide a global and regional overview of the level of implementation. The assessment reports also operate as a key feedback channel between the standard-setting and implementation-monitoring activities of the IAIS, by providing valuable information on the challenges faced in implementation of its standards and necessary revisions in its standards.

The IAIS's Strategic Plan and Financial Outlook 2015–2019 (SPFO) set a clear mission for the IAIS and identified specific strategies and action plans to guide the work on standards implementation and the activities of the Implementation Committee and its working parties. The SPFO and the mission statement of the IAIS together describe the overall approach towards achieving full and consistent implementation of IAIS standards. The mission statement of the IAIS, in particular, includes the objective to promote effective and globally consistent regulation of the insurance industry for the benefit and protection of policyholders, and to contribute to global financial stability.

The SPFO identifies main areas of work for the IAIS, which are addressed in the work of four subcommittees specially designated to address the major work streams to achieve the objectives of the SPFO and the IAIS mission statement. One of the subcommittees thus designated is the Standards Observance Subcommittee (SOS), which is mandated to focus on improving the implementation and observance of IAIS standards.

The work of the SOS includes developing self-assessment questionnaires and conducting thematic peer reviews of the IAIS Insurance Core Principles, as well as preparing individual country assessment reports and summary reports on the results of the assessments and peer reviews. The SOS also aims to provide useful information to the standard-setting and maintenance work of the IAIS by identifying issues faced by countries in implementation of the IAIS standards and ICPs. The feedback provided by SOS in this manner is expected to include identification of those ICPs which are inadequate in terms of clarity or completeness, and to identify training needs to the education subcommittee.

The activities of the IAIS and its SOS in respect of standards implementation and observance are heavily focused on supporting and enabling standards implementation, including provision of resources, training and capacity development among its membership, in order to implement the standards effectively.

4.3.16.7 Regulatory Consistency for the Islamic Financial Services Industry

In the Islamic finance domain, standards are issued by both the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) addressing various aspects and segments of the Islamic finance industry. Much like the wider financial services world, the Islamic finance sector would stand to benefit significantly from full and consistent implementation of prudential standards issued by the IFSB. The rationale cited in this report on the effect of full and consistent implementation in making the financial services sector sustainable and less risky applies to the Islamic finance domain equally. Towards this end, the concept of a concerted effort to monitor implementation of Islamic finance standards to ensure full and consistent implementation is vital.

The IFSB has already demonstrated its commitment to its goal of ensuring timely, complete and consistent implementation of its standards among its member jurisdictions in much the same way as that adopted by the BCBS and other global standard setters. The IFSB has addressed this objective by including measures in its annual plan of programs which include, but are not limited to, IFSB Annual Implementation Surveys, Facilitating the implementation of Standards workshops, and technical assistance missions to member jurisdictions. The IFSB has, in December 2015, extended its FIS activities by launching the FIS E-Learning Portal, which is expected to significantly enhance the scope of its FIS programme. The FIS E-learning portal complements the other components of the FIS programme, such as workshops, technical assistance missions, guidance notes and technical notes, in furthering understanding and adoption of IFSB standards.

In addition to FIS initiatives, the IFSB has been providing assistance to member jurisdictions by responding to written queries, reviewing draft laws and regulations, and carrying out annual standards implementation surveys. The annual IFSB implementation surveys have been useful in providing an updated status of the pace and completeness of implementation of its standards among its members. These surveys have so far been based on collecting necessary information from its member jurisdictions by way of questionnaires and using the information collected in an off-site assessment process. These surveys are also unique in respect of their focus not being limited to gathering data on implementation status but also seeking information about challenges faced by member jurisdictions in implementing standards. The information collected by way of these surveys has aided the IFSB's efforts to fine-tune its standards development as well as FIS initiatives to suit the needs and constraints faced by its member jurisdictions. The data collected through the annual surveys has helped the IFSB to promptly identify the areas that needed attention in terms of difficulties faced by members and the potential need for technical assistance in standards implementation. Consequently, the IFSB considered many of the points identified thus, in shaping the IFSB's SPP 2016–2018 and also resulted in realignment of processes.

Ensuring regulatory consistency of IFSB standards with the Basel framework on risk-based capital adequacy requirements would enhance the assessment of financial stability of the Islamic banking sector in the IFSB member countries. The IFSB's database for Prudential and Structural Islamic Financial Indicators can contribute to that extent where the participating PSIFI member countries are reporting risk-based capital adequacy indicators in line with both Basel and IFSB standards for their Islamic banking sector. Since standards/guidelines on risk-based capital adequacy requirements issued both by Basel and the IFSB are closely aligned with each other, the reported PSIFIs would contribute to transparency and comparability of compliance rates for the Islamic banking sector in member jurisdictions. Noting that among the BCBS's targeted countries for its Regulatory Consistency Assessment Programme are three G-20 countries – Indonesia, Saudi Arabia and Turkey – which are also PSIFI data-reporting countries, and that the BCBS has already completed the RCAP for Saudi Arabia in 2015 and has planned its RCAPs for Indonesia and Turkey in 2016, the PSIFI database can contribute to greater consistency and monitoring of the implementation of risk-based capital standards in these countries.

The IFSB has also completed a comparative study on implementation of a select set of IFSB standards and published a Working Paper on its findings in October 2015. This study focused on four standards pertaining to the Islamic banking sector, which were dispersed across the spectrum of regulatory standards ranging from prudential standards to Sharīʻah governance. The study has identified some of the factors that hamper the implementation of IFSB standards, such as inadequate resources and capacity, and varying levels of evolution in financial markets, among others. The Working Paper also observed the need for institutional development as a necessary complement to standards implementation, which hampers the ex-post consistency in the implementation of standards in diverse markets spread across various regions and operating in diverse legal and regulatory frameworks.

4.3.17 Conclusion and Moving Forward

The results of the implementation monitoring reviews carried out so far by the BCBS under RCAP and other similar reviews have clearly demonstrated their utility in supporting a higher level of compliance with regulatory standards, as well as more consistent implementation of standards across national jurisdictions. The achievement of these objectives is seen as contributing to the promotion of financial stability at both the national and global level. Given this background, it is expected that the FSB and its directing body, the G-20 leadership, will continue to maintain the high level of current emphasis on implementation monitoring and consistency assessments.

Given the rapid progress achieved in covering its membership under the RCAP in the three-year period since its launch in 2012, the BCBS is currently reviewing the RCAP with the aim of further enhancing the effectiveness of its implementation work. For example, the BCBS has revised its handbook for jurisdictional assessments, published in March 2016, as well as made revisions to its monitoring template and report to take into account new or revised standards. It has also commissioned a study to review the progress of the RCAP and the strategic direction of the BCBS's implementation mandate. Similarly, the IAIS and IOSCO assessments are likely to develop in this direction, given their focus on implementation monitoring in the form of thematic studies and peer reviews.

The implementation monitoring and consistency assessments are likely to become an integral part of the programme of work for other global standard setters, including the IFSB. This likely expansion in coverage to other segments of the financial markets such as the Islamic segment may be driven by the value placed on consistent implementation of global standards by the market participants and their assessment of the impact on overall systemic stability or health of the financial institutions in a particular sector.

The IFSB intends to enhance the utility of this monitoring programme by expanding its scope to assess the consistency and effectiveness of implementation of IFSB standards. Initially, the IFSB may focus on thematic reviews through surveys based on off-site data collection from regulatory and supervisory authorities addressing, potentially, the risk-weighting of credit risk exposures in Sharīʻah-compliant products or contracts, the risk-weighting of exposures arising from profit-sharing contracts, capital adequacy standards for *sukūk* and securitisations, capital adequacy for real estate investments, and the treatment of PSIAs with a specific emphasis on application of the Alpha factor. This indicative set of areas for monitoring, and implementation monitoring, might be expanded to address other aspects of Islamic finance if the risks and trends observed point to a need.

The IFSB may also employ these thematic reviews to assess the implementation of a specific core principle or a specified set of core principles for Islamic finance regulation. It may, at a later stage, consider the use of on-site reviews with a plan for peer reviews in much the same way as the BCBS is pursuing its efforts as part of the RCAP. Such reviews would, however, require substantial planning and commitment of human and financial resources by the IFSB as well as by its member jurisdictions.

This would be in addition to the application of similar regulatory consistency programmes addressing the implementation of global standards from the BCBS, IOSCO and IAIS, but it would be a valuable addition for countries with a material share of Islamic finance in their financial services industry. Such an approach will be consistent with the emphasis of the FSB and the course adopted by the global standard setters who have moved on to the stage of consistency and completeness assessment.

The IFSB can also expand its work in this area by providing guidance material for implementation of standards, and by enhancing the training for regulatory staff of its members, both of which will be useful in helping its members to improve the level and consistency of implementation of IFSB standards.

Overall, the relevance of implementation monitoring and consistency assessment programmes such as the RCAP to IFSB membership is likely to increase, bringing more of the IFSB membership into the scope of one or the other assessment reviews.

Box 4.3.1 EBA Work on Convergence of Banking Supervisory Practices in the European Union

By Slavka Eley, Oleg Shmeljov, Alessandro Nardi, Supervisory Convergence Unit, European Banking Authority[258]

Setting the scene for supervisory convergence

The financial crisis that started in 2007 exposed important shortcomings in European Union (EU) financial supervision. Nationally based supervisory models and approaches have lagged behind financial globalisation and the integrated and interconnected financial markets, in which many financial institutions operate across borders. The crisis also exposed weaknesses in the areas of cooperation, coordination, consistent application of EU law and trust between national supervisors. The deficiencies in the pre-crisis supervisory models have led to improvements in national models, but also to a search for pan-European solutions leading to the creation of the European System of Financial Supervisors (ESFS) and European Supervisory Authorities (ESAs), including the European Banking Authority (EBA). The objectives set for those authorities included improving the quality and consistency of national supervision, strengthening oversight of cross-border groups and establishing a European Single Rulebook (set of rules and standards together with the EU Regulations and Directives)[259] applicable to all financial institutions in the EU Single Market,[260] and playing a strong role in crisis situations.

The smooth operation of the Single Market requires enhanced convergence of not only regulations, but also supervisory practices between the supervisory authorities. Despite the existence of common rules, divergent supervisory practices and outcomes pose a potential risk to the effective oversight of cross-border groups and the development of a level playing field in financial services.

Against this backdrop, the work on the convergence of supervisory practices across the EU is one of the cornerstones of the EBA mandate. The aim of this work is to ensure that we have good-quality supervision that is based on compliance with the Single Rulebook, leading to consistent and comparable supervisory outcomes; in other words, our fundamental objective is to achieve a situation where institutions with similar risk profiles, business models and geographic exposures, but which operate and are supervised in different member states, are reviewed and assessed by supervisory authorities consistently and are subject to broadly comparable supervisory expectations, actions and measures.

EBA supervisory convergence mandate

In line with its Founding Regulation, which requires the EBA to actively foster supervisory convergence across the EU with the aim of establishing a common supervisory culture, the EBA convergence mandate can be split into four main themes:

- ensuring convergence of supervisory practices in the area of the supervisory review and evaluation process (SREP);
- building a common supervisory culture, including by means of a European Supervisory Handbook and various training activities;

[258] Views presented in this paper are those of the authors and do not necessarily represent views of the European Banking Authority
[259] Read more about the Single Rulebook at www.eba.europa.eu/regulation-and-policy/single-rulebook.
[260] "Single Market" refers to the EU as one territory without any internal borders or other regulatory obstacles to the free movement of goods and services. (See more at http://ec.europa.eu/growth/single-market/index_en.htm.)

- ensuring convergence and consistency in the functioning of colleges of supervisors; and
- assessing the level of convergence achieved, including by means of conducting peer reviews of authorities.

To operationalise these themes, the EBA has several tools at its disposal, including:

- developing policy products, including certain aspects of the Single Rulebook, guidelines and Supervisory Handbook, addressed to supervisors and dealing with supervisory processes and methodologies;
- training of supervisors across the EU to ensure a common foundation and culture for supervision;
- direct participation in colleges of supervisors, feedback and assessment of their functioning to ensure cooperation and effective joint risk assessments and joint decisions for cross-border operating banks and their subsidiaries;
- ensuring effective application of the Single Rulebook and effective assessment thereof; and
- mediation in the event of misunderstandings or disagreements between the authorities involved in the supervision of cross-border groups.

Convergence of supervisory practices in SREP

Under its convergence mandate the EBA issued in December 2014 its guidelines on common procedures and methodologies for SREP (“SREP Guidelines”).[261] These Guidelines cover all aspects of on-going supervision of an institution, bringing together outcomes of all activities supervisors would perform (including off-site and on-site analysis) into a comprehensive supervisory view considering the overall viability of an institution given its risk profile, business model and capital and liquidity. The common European SREP framework introduced by these Guidelines to be applied starting from 2016 is built around the assessment of four major building blocks: (1) business model analysis; (2) assessment of internal governance and institution-wide controls; (3) assessment of risks to capital and capital adequacy; and (4) assessment of risks to liquidity and funding and adequacy of liquidity resources. The Guidelines introduce a common supervisory assessment process that should be applied proportionately to various categories of institutions, provide clarity on the common scoring methodology as well as on how to determine, definite and communicate to institutions additional capital and liquidity requirements (Pillar 2 requirements). In its SREP Guidelines the EBA also explained the role of stress testing and capital buffers in relation to Pillar 2 requirements.

During 2015, in the run-up to the practical implementation of the Guidelines by supervisors, the EBA focused on supporting authorities in their implementation activities, including by running several outreach training sessions across the EU. Furthermore, the EBA has continued with the development of additional guidelines supporting the consistent implementation of SREP Guidelines, and in particular draft Guidelines on stress testing and supervisory stress testing,[262] and on the collection of information regarding institutions’ internal capital adequacy assessment (ICAAP) and internal liquidity adequacy assessment (ILAAP) processes.[263]

The SREP Guidelines also provide a solid background for the work of colleges of supervisors, as the common framework would better facilitate joint risk assessments done by colleges and their joint decision on institutions-specific prudential requirements.

Supervisory Handbook

The EBA believes that, in addition to developing technical standards and guidelines, there is also room for a more practically oriented product that would accompany the Single Rulebook and provide line supervisors/examiners with the examples of best supervisory practices, case studies, supervisory questionnaires, etc. that they could use in their daily supervisory activities. This is achieved by a legally non-binding Supervisory Handbook being currently developed by the EBA in cooperation with national authorities.

The EBA Handbook is of modular design with the current high-priority modules covering emerging supervisory topics such as: (1) business model analysis; and (2) assessment of recovery plans that are practically oriented and provide examples, case studies and supervisory metrics. Being a supervisory tool, the Handbook is available to

[261] Read more about the guidelines at www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-for-common-procedures-and-methodologies-for-the-supervisory-review-and-evaluation-process-srep-
[262] The consultation paper can be accessed here: www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-stress-testing-and-supervisory-stress-testing.
[263] The consultation paper can be accessed here: www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/guidelines-on-icaap-and-ilaap-information.

all EU supervisors, while not being externally published. In addition to providing value added to line supervisors, the EBA intends to use the examples of best practices set out in the Handbook as benchmarks in its assessment of convergence, including the peer reviews of supervisory practices.

Effective and efficient functioning of colleges of supervisors

Promoting effective and efficient functioning of colleges of supervisors that have been set up in the EU to facilitate the supervision of cross-border banking groups since 2010 has been an important task for the EBA since its inception. The EBA is actively involved in the work of colleges by means of: (1) setting standards and guidance for their functioning, including for the organisation of various joint decisions processes, namely on institutions-specific prudential requirement; (2) setting annual college actions plans and monitoring their fulfilment; and, above all, through (3) direct participation in all college activities as a member, and monitoring of actual practices within the colleges. This three-fold engagement allows the EBA staff participating in colleges work to identify and promote best supervisory practices, advise on the implementation of EBA guidelines, and provide a feedback loop between the EBA risk analysis and monitoring work and institution-specific supervisors.

To ensure that colleges perform adequately, the EBA also monitors their performance against the Single Rulebook, guidelines and annual action plans. Such monitoring is based on information collected and activities performed directly by the EBA staff and, over the years, has developed into a structured deep-dive assessment, summarised annually in the "colleges' scorecard" and a report on the functioning of colleges.[264] The outcome of assessment of individual colleges is also shared in a restricted format with the members of the EBA Board of Supervisors. Every year the assessment provides deeper overview of progress and challenges and helps also to identify areas for further work on supervisory methodologies.

Assessment of convergence

Assessment of convergence in supervisory practices is based around (1) peer reviews conducted by supervisory authorities through the framework of the Review Panel, (2) specialist reviews conducted by the EBA staff thought the dedicated stocktakes and discussions in various internal EBA fora, leading to (3) an annual convergence report prepared in a public[265] or confidential format focusing on the mapping of certain areas of supervisor work, comparing practices and identifying progress in achieving convergence.

The focus of peer reviews largely lies on the application of technical standards and implementation of EBA guidelines by national authorities. These are relatively complex exercises run by the dedicated Review Panel consisting of representatives of all EU banking supervisory authorities, and are built in various stages starting from the self-assessments that are focused on how authorities are applying EBA standards and guidelines in practice and that are performed by authorities, and then comparing/reviewing these self-assessments by other authorities (review by peers). The outcomes of peer reviews may lead to a set of recommendations to authorities and/or the EBA to consider further policy work. One particular example of such a feedback-loop is the use of outcomes of peer review of stress testing contributing to the revision of the EBA Guidelines on stress testing and supervisory stress testing.

Contrarily to more formal peer reviews, the specialist reviews are more agile and less resource intensive, as their focus is generally more limited on areas of particular interest or technical topics, such as recent reviews of consistency of risk-weighted assets, or benchmarking of remuneration practices. Such specialist reviews are mostly EBA staff led and are based around dedicated stocktakes and open discussions in various EBA standing committees (which are attended by representatives of all supervisory authorities). Such reviews help to identify commonalities and divergences, emerging issues or inconsistencies of supervisory practices and processes, and can help in enhancing understanding among supervisors and identification of methods to take the findings forward. There are, of course, limitations, as reviews are often based just on snapshots in time and do not allow coverage of further evolution. Also, reliance on answers to questionnaires may be a limitation in its own right as such information might not be neutral.

[264] The latest report on college functioning can be accessed here: www.eba.europa.eu/documents/10180/1042260/Accomplishment+of+2014+EBA+Colleges+Action+Plan+and+2015+EBA+Colleges+Action+Plan.pdf/a364a46b-d39b-4b57-996f-e30aab4b193c.

[265] See the first report on convergence of supervisory practices here: www.eba.europa.eu/documents/10180/950548/Supervisory+convergence+report.pdf/9f49ddf9-232f-4062-b34e-ff671d440081

Challenges and achieving convergence and way forward

Convergence of supervisory practices comes with its challenges, as despite all authorities contributing to the work of the EBA and development of common standards and guidelines, at the national level they tend to preserve their own supervisory methodologies, "national identity" and practices reflecting their past experience and also the structure and governance of their organisations. This is one of the main obstacles in achieving convergence. To this end, it should be noted that the consistent implementation of SREP Guidelines would require absolutely all authorities to make adjustments to their past approaches whilst leaving ample scope for proportionality, supervisory judgement, and working with banks' own and varied risk management frameworks. However, if authorities do not adapt to find this vital common ground, divergence in supervisory practices may create the risk of an un-level playing field, fragmentation and costly inefficiencies in the functioning of the EU Single Market.

Another challenge for achieving greater supervisory convergence lies sometimes in flexibility in technical standards and guidelines left there following the negotiation of the final products. Such flexibility often leaves room for interpretation at the national level. It has been also observed that the parts of the Single Rulebook addressed to supervisory authorities are not used directly as applicable legal rules, but are implemented via the internal procedures and manuals of the supervisory authorities. This might lead again to different implementation and use of the same rules.

To address these challenges, the EBA is stepping up its work on actual monitoring of supervisory practices observed in the work of colleges of supervisors and regular assessment of convergence. Having access to the outcomes of the supervisory assessments and measures applied to institutions, we will be able to understand the risk profiles of various banks as assessed by supervisors and see whether the supervisory response is consistent and proportionate across the EU. We also plan to follow closely how authorities are implementing EBA guidelines in practice, by running various analytical exercises led by the EBA staff and through our peer reviews frameworks. The outcomes of such analytical efforts will be summarised in the annual convergence reports, and reports on the functioning of colleges of supervisors, and may lead to further policy work or development of additional modules of the Supervisory Handbook.

Lastly, it should be noted that in the EBA convergence work we are not seeking full harmonisation or a "one-size-fits-all" approach to supervision across the EU as we recognise the differences and need to maintain room for supervisory judgements that are tailored to specific circumstances. However, given the recent changes in the EU banking supervisory landscape and the creation of the Single Supervisory Mechanism (SSM) and the consolidation of supervision of the largest banks in the Eurozone under the European Central Bank, the question of supervisory convergence takes on a new dimension. The creation of the SSM will, de facto, harmonise supervisory practices within the SSM participating countries, thus contributing to even more convergence across the whole of the EU. But one should also acknowledge the potential, however remote, of an inadvertent "two-speed" process, and the potential for fragmentation of the Single Market in the shadows of more harmonisation of supervisory practices within the SSM, where non-participating authorities may seek their own way. Therefore, the EBA work on supervisory convergence takes on a new meaning as we need to ensure that changes in one area do not lead to divergences with other, non-participating jurisdictions, in a way that damages both the integrity of the EU Single Market and the level playing field.

5.0 CONCLUDING REMARKS

The IFSI continued its overall growth both in terms of US Dollars and market shares. However, growth rates have slowed down and the economic environment has become more unfavourable since 2014. It is expected to continue to be challenging in the coming years, with volatile financial markets, depreciations of emerging market currencies, a weak global economy, political crises, and depressed commodity prices in general and oil prices in particular. This unfavourable economic environment poses operational challenges to Islamic finance, makes forecasts difficult and inhibits qualitative progress.

Strategies and Quantities

Islamic banking will remain the dominant sector of the IFSI. In the past, many Islamic banks were highly liquid and short of attractive investment opportunities. This constellation may turn into the opposite: windfall liquidity from oil exports at continuously rising prices will dry up, and so will the inflow of deposits from governments and government-related entities into the Islamic banks. On the other hand, new investment opportunities will emerge if governments revert to banks and capital markets for the financing of ongoing infrastructure projects. The business profiles of Islamic banks may change somewhat from traditional retail banking with a large share of consumer and home financing to more investment banking with significant engagements in project financing, including syndicated financing, securitisations and capital market (*sukūk*) transactions.

This may be a correct description of the situation in many jurisdictions, including most of the largest Islamic finance markets. However, the aggregate figures of the IFSI are largely determined by Iran, which actually accounts for 37% of the total Islamic banking assets. This country will benefit from the suspension of sanctions and should be able to increase its national income substantially even at the current low oil prices. It is expected that the Iranian currency will appreciate against the US Dollar, and this could not only boost its share in total Islamic banking assets significantly but also increase the size of the global IFSI. Obviously, highly aggregate figures can easily be misinterpreted – whether unintentionally or intentionally. In a period of discontinuities in time series or even reversing trends, it is important to collect and evaluate industry data on a more disaggregate sectoral and regional level. Unfortunately, Islamic finance is clearly lagging behind conventional finance with regardto the quantity and quality of data required for, among other things, calibration of risk weights, the modelling of sectoral interdependencies, stress testing, or the analysis of systemic risks.

Regulatory Developments

It seems that the speed of regulatory reforms in conventional finance has accelerated. Last year's regulatory output of the FSB and the three global standard setters for banking, capital markets and insurance is impressive. In Islamic finance, only the IFSB acts as a global standard setter for prudential regulations, and the high speed of reforms in conventional finance has made it necessary that a recently (December 2013) revised comprehensive and fundamental standard – IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes – must again be updated and amended in several respects outlined in this report. With all the ongoing reform activism, it is important to ensure the consistency of existing and new regulations. The task is even more complicated in Islamic finance than in conventional finance because the standard setter has to ensure consistency not only within the family of Islamic finance standards, but also between conventional and Islamic regulations. This is further aggravated by the fact that prudential standards for Islamic finance have to be implemented primarily in financial systems of emerging markets and developing countries where significant parts of global standards may not be of relevance due to an early stage of financial-sector development with incomplete or non-existing capital or insurance markets.

In the new IFSB Strategic Performance Plan 2016–2018, the Council has approved a work plan of producing new prudential standards, guidelines and research papers that exhibit a consensus among its stakeholders on priorities for the work plan of the coming years. However, the IFSB may also need to respond, should the need arise, to new and urgent developments in conventional finance.

Conceptual Challenges

The acceptance of Islamic finance as an alternative to conventional finance by Muslims and non-Muslims can be seen as one of the conceptual challenges of the IFSI. This report provides indications for some success in this regard: (1) Islamic finance has taken root in North and Sub-Saharan Africa, where a number of new Islamic banks have been established; (2) Oman and Cote d'Ivoire were two new sovereign issuers of *sukūk* in 2015; and (3) the first guarantee for a USD913 million *sukūk* of a government-owned company in Dubai (Emirates Airlines) by a government-backed export credit guarantee agency of a Western country, UK Export Finance, was taken as confirmation of the commitment of the British government to Islamic finance. The purpose of the *sukūk* was the purchase of Airbus A380 aircraft.

However, the report also provides examples of where the acceptance by Muslims is questionable and conceptual challenges still persist.

The summary of recent developments in financial inclusion and Islamic microfinance can hardly be read as a great success story. There are outlines of the specific microfinance approaches taken in one country with a totally Islamised financial system (Sudan), one country with an Islamic microfinance scheme driven by the largest private Islamic bank (Bangladesh), and a country where charity funds and Sharī'ah-compliant modes of financing are combined in Islamic microfinance (Indonesia). But even for these "case studies", let alone the other OIC countries, data on the penetration and effectiveness of Islamic microfinance compared to conventional alternatives are widely missing. The need for better data is obvious. But even without detailed statistics, it seems not unreasonable to assume that Islamic microfinance has not yet taken root in most Muslim-majority countries. A concept paper on the regulation and supervision of Microtakāful would help to prepare the ground for this segment of Islamic microfinance, but it cannot replace the institutions that have to deliver *microtakāful* products "on the ground".

Another sector where a conceptual challenge persists is (commercial) *takāful*. The IFSB has drafted Guiding Principles for *Retakāful* (Islamic Reinsurance), and there is indeed a relatively large number of *retakāful* operators active in the markets. However, *takāful* operators often still use conventional reinsurers instead of *retakāful* companies. They usually quote practical reasons for this. Increasing the capacity of *retakāful* undertakings and sorting out Sharī'ah and regulatory issues pose conceptual challenges that have to be addressed by the industry.

In another field, the practice of IIFS was such that the regulator saw a conceptual challenge and then took an important step. Based on the Islamic Financial Services Act 2013, Malaysia's central bank enforced recently the strict separation between Islamic deposits (with a capital guarantee but no returns) and investment accounts (based on profit-sharing and loss-bearing contracts). The former practice of smoothing of profit payouts for PSIAs is now prohibited for investment accounts, and these accounts are not covered by deposit insurance. Investment account holders have to be made aware of performance-related (instead of quasi-fixed) returns, and especially of the risk of capital losses. In this way, these investment accounts are now closer to collective investment schemes than to savings or term deposits, as they were in the past (and still are in most other jurisdictions). The introduction of a multi-bank investment account platform, and channelisation of funds to various emerging sectors such as SMEs and green energy, can provide a solution to many of the pitfalls of offering PSIA in dual banking environments. However, it remains to be seen whether this example has set a precedent that will be followed by other regulators in the future.

APPENDIX 1

Sample Methodology

Islamic Banking

Sample data were collected for 59 full-fledged Islamic banks in Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey and the United Arab Emirates. These countries were chosen because of the importance of Islamic banking in their respective banking systems, as well as for reasons of data availability. Total assets of the sample Islamic banks amounted to USD672.2 billion in 2014, or 71.6% of global Islamic banking assets (excluding Iran). Data collected covered the period from 2009 to 2014.

Islamic Banks Selected for the Sample

Bahrain	Al Baraka Islamic Bank
	ABC Islamic Bank
	Al Salam Islamic Bank
	Bahrain Islamic Bank
	Ithmaar Bank
	KFH Bahrain
	Khaleeji Commercial Bank
Bangladesh	Al-Arafah Islami Bank
	First Security Islami Bank
	Islami Bank Bangladesh
	Shahjalal Islami Bank
Jordan	Jordan Islamic Bank
	Islamic International Arab Bank
Kuwait	Ahli United Bank
	Boubyan Bank
	Kuwait Finance House
	Kuwait International Bank
Malaysia	Affin Islamic Bank
	Alliance Islamic Bank
	AmIslamic Bank
	Al Rajhi Bank (Malaysia)
	Asian Finance Bank
	Bank Islam
	Bank Muamalat
	CIMB Islamic Bank
	Hong Leong Islamic Bank
	HSBC Amanah Malaysia
	KFH Malaysia
	Maybank Islamic Bank
	OCBC Al-Amin
	Public Islamic Bank
	RHB Islamic Bank
	Standard Chartered Saadiq
Indonesia	Bank BRI Syariah
	Bank Muamalat Indonesia
	Bank Syariah Mandiri
	Bank Syariah Bukopin
	Bank Syariah Mega Indonesia
Pakistan	Al Baraka Bank (Pakistan)
	BankIslami
	Dubai Islamic Bank (Pakistan)
	Meezan Bank
Qatar	Barwa Bank
	Masraf Al Rayan
	Qatar International Islamic Bank
	Qatar Islamic Bank
Saudi Arabia	Alinma Bank
	Al Rajhi Bank
	Bank AlBilad
	Bank AlJazira
Turkey	Al Baraka Turk Participation Bank
	Bank Asya Participation Bank
	Kuveyt Turk Participation Bank
	Turkiye Finans Participation Bank
United Arab Emirates	Abu Dhabi Islamic Bank
	Ajman Bank
	Dubai Islamic Bank
	Emirates Islamic Bank
	Sharjah Islamic Bank

Takāful

Sample data were collected for 30 full-fledged *takāful* operators in Bahrain, Bangladesh, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Sri Lanka and the United Arab Emirates. These countries were chosen because of the relative importance of *takāful* in their respective insurance markets and, more importantly, for reasons of data availability. Total gross contributions of the sample *takāful* operators amounted to USD581.5 million in 2014. Data collected covered the period between 2009 and 2014.

Takāful Operators Selected for the Sample

Bahrain	Takaful International Co.
Bangladesh	Islami Insurance Bangladesh
	Padma Islami Life Insurance
Kuwait	Gulf Takaful Insurance Co.
	Wethaq Takaful Insurance Co.
Malaysia	Etiqa Insurance & Takaful
	Great Eastern Takaful
	Hong Leong MSIG Takaful
	Prudential BSN Takaful
	Takaful Ikhlas
	Takaful Malaysia
Pakistan	Dawood Family Takaful
	Pak Kuwait Takaful Co.
	Pak Qatar Family & General Takaful
Sri Lanka	Amana Takaful
Qatar	Doha Insurance
	Qatar Islamic Insurance Co.
Saudi Arabia	Al-Ahli Takaful Co.
	Allianz Saudi Fransi
	Allied Cooperative Insurance Group
	Gulf Union Insurance and Risk Management Co.
	Al Sagr Cooperative Insurance Co.
	BUPA Arabia for Cooperative Insurance
	SABB Takaful Co.
	Saudi Arabian Cooperative Insurance Co.
	Saudi United Co-operative Insurance Co.
	The Company for Cooperative Insurance (Tawuniya)
United Arab Emirates	Abu Dhabi National Takaful Co.
	Dar Al Takaful
	Islamic Arab Insurance Co. Salama

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